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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No.* SR - 2014 - * 048

Amendment No. (req. for Amendments *)

Filing by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial *	Amendment *	Withdrawal	Section 19(b)(2) *	Section 19(b)(3)(A) *	Section 19(b)(3)(B) *
☑	☐	☐	☑	☐	☐

Pilot ☐

Extension of Time Period for Commission Action * ☐

Date Expires *

Rule

19b-4(f)(1) 19b-4(f)(4)
19b-4(f)(2) 19b-4(f)(5)
19b-4(f)(3) 19b-4(f)(6)

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010

Section 806(e)(1) * ☐

Section 806(e)(2) * ☐

Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934

Section 3C(b)(2) * ☐

Exhibit 2 Sent As Paper Document

Exhibit 3 Sent As Paper Document

Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked *).

Proposed Rule Change to Adopt FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports)

Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * Philip Last Name * Shaikun

Title * Vice President and Associate General Counsel

E-mail * philip.shaikun@finra.org

Telephone * (202) 728-8451 Fax (202) 728-8264

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date 11/14/2014

By Patrice Gliniecki

(Name *)

(Title *)

Senior Vice President and Deputy General Counsel

Patrice Gliniecki,

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information * Add Remove View	The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.
Exhibit 1 - Notice of Proposed Rule Change * Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO] -xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies * Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO] -xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications Add Remove View Exhibit Sent As Paper Document ☐	Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.
Exhibit 3 - Form, Report, or Questionnaire Add Remove View Exhibit Sent As Paper Document ☐	Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.
Exhibit 4 - Marked Copies Add Remove View	The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.
Exhibit 5 - Proposed Rule Text Add Remove View	The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.
Partial Amendment Add Remove View	If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act"),[1] Financial Industry Regulatory Authority, Inc. ("FINRA") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to adopt new FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) to address conflicts of interest relating to the publication and distribution of debt research reports.

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

At its meeting on July 11, 2013, the FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

[1] 15 U.S.C. 78s(b)(1).

Background

The proposed rule change would adopt FINRA Rule 2242 to address conflicts of interest relating to the publication and distribution of debt research reports. Proposed FINRA Rule 2242 would adopt a tiered approach that, in general, would provide retail debt research recipients with extensive protections similar to those provided to recipients of equity research under current and proposed FINRA rules, with modifications to reflect differences in the trading of debt securities.[2]

Currently, FINRA's research rules, NASD Rule 2711 (Research Analysts and Research Reports) and Incorporated NYSE Rule 472 (Communications with the Public) (the "equity research rules"), set forth requirements to foster objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions. The equity research rules apply only to research reports that include analysis of an "equity security," as that term is defined under the Exchange Act,[3] subject to certain exceptions.[4] The equity research rules were intended to restore public confidence in the objectivity of research and the veracity of research analysts, who are expected to function as unbiased intermediaries between issuers and the investors who

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2 The proposed rule change reflects proposed amendments to FINRA's equity research rules set forth in a companion filing to the proposed rule change (the "equity research filing"). See SR-FINRA-2014-047.

3 See 15 U.S.C. 78c(a)(11).

4 In contrast to FINRA's current research rules, SEC Regulation Analyst Certification ("Regulation AC"), the SEC's primary vehicle to foster objective and transparent research, applies to both debt and equity research. See 17 CFR 242.500 et seq.

buy and sell those issuers' securities.[5] The integrity of research had eroded due to the pervasive influences of investment banking and other conflicts during the market boom of the late 1990s.

In general, the equity research rules require disclosure of conflicts of interest in research reports and public appearances by research analysts. The equity research rules further prohibit conflicted conduct – investment banking personnel involvement in the content of research reports and determination of analyst compensation, for example – where the conflicts are too pronounced to be cured by disclosure. Several requirements in the equity research rules implement provisions of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which mandates separation between research and investment banking, proscribes conduct that could compromise a research analyst's objectivity and requires specific disclosures in research reports and public appearances.[6] The Sarbanes-Oxley research provisions do not apply to debt research.

In December 2005, in response to a Commission Order, FINRA and NYSE Regulation, Inc. ("NYSE") submitted to the Commission a joint report on the operation and effectiveness of the research analyst conflict of interest rules (the "Joint Report").[7]

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5 NASD Rule 1050 (Registration of Research Analysts) and Incorporated NYSE Rule 344 (Research Analysts and Supervisory Analysts) require any person associated with a member and who functions as a research analyst to be registered as such and pass the Series 86 and 87 exams, unless an exemption applies. FINRA is considering whether debt research analysts also should be subject to the same or a similar qualification requirement.

6 15 U.S.C. 78o-6.

7 Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (December 2005), available at http://www.finra.org/web/groups/industry/@ip/@issues/@rar/documents/industry/p015803.pdf.

Among other things, the Joint Report analyzed the impact of the equity research rules based on academic studies, media reports and commentary. The Joint Report concluded that the equity research rules have been effective in helping to restore integrity to research by minimizing the influence of investment banking and promoting transparency of other potential conflicts of interest. Evidence from academic studies, among other sources, further suggested that investors are benefiting from more balanced and accurate research to aid their investment decisions. A January 2012 GAO report on securities research ("GAO Report") also concluded that empirical studies suggest the rules have resulted in increased equity analyst independence and weakened the influence of conflicts of interest on analyst recommendations.[8]

The Joint Report also recommended changes to the equity research rules to strike a better balance between ensuring objective and reliable research on the one hand, and permitting the flow of information to investors and minimizing costs and burdens to members on the other.[9] The proposed rule change is informed by FINRA's experience with and the effectiveness of the equity research rules and incorporates many of the findings and recommendations from the Joint Report.

A number of events and circumstances contributed to FINRA's determination that a dedicated debt research rule is needed to further investor protection. In 2004, the Bond Market Association ("BMA") published its Guiding Principles to Promote the Integrity of

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8 United States Government Accountability Office, Securities Research, Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest, January 2012.

9 The basis for the recommended changes to the equity research rules is described in more detail in the equity research filing. See supra note 2.

Fixed Income Research ("Guiding Principles"),[10] a set of voluntary guidelines intended to foster management and transparency of conflicts of interest with respect to debt research. The Guiding Principles acknowledge that potential conflicts of interest could arise in the preparation of debt research, and many of the principles to maintain integrity of debt research hew closely to the equity research rule requirements. The Guiding Principles also reflect what the BMA asserted are several significant differences in the role and impact of research on the equity and fixed income markets, as well as differences in research regarding individual fixed-income asset classes. For example, the BMA contended that the prices of debt securities were less sensitive to the views of research analysts and that the major rating agencies provided a reliable source of independent information for the debt markets. It also asserted that most debt research was provided to sophisticated market participants for which it serves as one of many sources of information to consider when making an investment decision.

The Joint Report discussed the need for rules to govern debt research distribution. NASD and NYSE indicated that they would examine the extent to which firms voluntarily adopted the Guiding Principles and would consider further rulemaking after assessing the effectiveness of voluntary compliance. The Joint Report noted that the anti-fraud statutes and existing NASD and NYSE broad ethical rules could reach instances of misconduct involving debt research. NASD and NYSE subsequently surveyed a selection of firms' debt research supervisory systems and found many instances where firms failed to adhere to the Guiding Principles. More significantly, NASD and NYSE found cases where firms lacked any policies and procedures to manage debt research

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10 In 2005, the BMA merged with the Securities Industry Association ("SIA") to form the Securities Industry and Financial Markets Association ("SIFMA").

conflicts to ensure compliance with applicable ethical and anti-fraud rules. Those findings were published in Notice to Members 06-36,[11] where FINRA expressly noted that it would continue to consider more definitive rulemaking that might differ from or expand on the Guiding Principles.[12]

Following publication of its findings in 2006, FINRA continued to examine whether firms had implemented and enforced supervisory policies and procedures to promote the integrity of debt research and address attendant conflicts of interest. As noted in the GAO Report, between 2005 and 2010, FINRA conducted 55 such examinations and found deficiencies involving inadequate supervisory procedures to manage debt research conflicts or failure to disclose such conflicts in 11 (20%) examinations. The GAO Report stated that most market participants and observers that the GAO interviewed "acknowledged that additional rulemaking is needed to protect investors, particularly retail investors." The GAO Report concluded that "until FINRA adopts a fixed-income research rule, investors continue to face a potential risk."

Following the consolidation of NASD and the member regulatory functions of NYSE Regulation, Inc. into FINRA, and as part of the process to develop the consolidated FINRA rulebook,[13] FINRA conducted a comprehensive review of all of its

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11 Notice to Members 06-36 (July 2006).

12 As noted in the 2005 report, FINRA believes that the anti-fraud statutes, as well as existing FINRA rules, such as the requirement in FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) that members, in the conduct of their business, "observe high standards of commercial honor and just and equitable principles of trade," can reach any egregious conduct involving fixed-income research.

13 The current FINRA rulebook includes, in addition to FINRA Rules, (1) NASD Rules and (2) rules incorporated from NYSE ("Incorporated NYSE Rules") (together, the NASD Rules and Incorporated NYSE Rules are referred to as the

research rules and considered the appropriateness of adopting a dedicated rule to address potential conflicts of interest in the publication and distribution of debt research reports. In addition to its examination findings, and later, the conclusions of the GAO Report, several other factors also weighed in FINRA's decision to propose dedicated debt research conflict of interest rules. Misconduct in the sale of auction rate securities (i.e., debt traders pressured research analysts to help prop up the market with optimistic research) demonstrates that potential conflicts of interest in the publication and distribution of debt research can exist just as they do for equity research.[14] Also, the reliability of credit agency ratings was called into question during the financial crisis that began in 2008. Furthermore, the Dodd-Frank legislation in response to that crisis has resulted in rules by the Commodity Futures Trading Commission ("CFTC") to govern conflicts of interest regarding non-security-based swaps and commodities research, and the SEC has proposed rules that would require security-based swap dealers and major security-based swap participants to adopt written policies and procedures to address conflicts related to security-based swaps and research. Based on the foregoing considerations, and consistent with the regulatory trend to require mitigation and transparency of conflicts related to all types of investment research, FINRA believes it

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"Transitional Rulebook"). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE ("Dual Members"). For more information about the rulebook consolidation process, see Information Notice, March 12, 2008 (Rulebook Consolidation Process).

14 See e.g., SEC Finalizes ARS Settlements With Bank of America, RBC and Deutsch Bank, Litigation Release No. 21066, 2009 SEC LEXIS 1799 (June 3, 2009); SEC Finalizes ARS Settlement With Wachovia, Litigation Release No. 20885, 2009 SEC LEXIS 282 (February 5, 2009); SEC Finalizes Settlements With Citigroup and UBS, Litigation Release No. 20824, 2008 WL 5189517 (December 11, 2008).

necessary and appropriate to provide better protections to recipients of debt research, particularly less sophisticated investors. FINRA's belief is buttressed by observations of retail investment in debt securities. For example, FINRA TRACE data shows that from 2007 through 2013, retail-sized transactions (defined to mean trades with a face value of less than $100,000) in corporate bonds increased approximately 97 percent to about 16,000 daily trades.

In developing the proposed rule change, FINRA recognized that the debt markets operate differently from the equity markets in some respects. Several of the differences were noted by the BMA in the release accompanying the Guiding Principles. For example, the debt markets feature a number of different asset classes (e.g., corporate, high yield, mortgage backed and asset-backed) with unique characteristics. Within each class, there are typically many issues with similar terms, creating a fungibility of securities that doesn't exist to the same extent in the equity markets. As the BMA noted, these securities are often priced in relation to benchmark securities or interest rate measures, and their prices tend to depend more on interest rate movements and other macroeconomic factors than issuer fundamentals, although an issuer's ability to service its debt remains an important factor. As a result of these dynamics, it is less likely that a debt research report will influence the price of a subject company's debt securities than an equity report will impact the price of that company's equity securities. Also, while retail and institutional market participants invest in both equity and debt securities, relative to the equity markets, the debt markets are dominated by institutional market participants.

The nature of the debt markets has resulted in several different types of debt research. There is debt research that focuses on the creditworthiness of an issuer or its individual debt securities. Debt research reports on individual debt securities may look at the relative value of those securities compared to similar securities of other issuers. Some debt research compares debt asset classes or issues within those asset classes. And in light of the importance of interest rates on the price of debt securities, much of the research related to debt analyzes macroeconomic factors, monetary policy and economic events without reference to particular assets classes or securities. While much of this research is prepared by a dedicated research department, FINRA also understands that trading desks generate market color, analysis and trading ideas, sometimes known as "trader commentary," geared towards institutional customers. FINRA understands from those participants that they value timely information from the trading desk and incorporate that information into their own analysis when making an investment decision about debt securities. As discussed in more detail below, the tiered structure of the proposed rule change and the definition of "debt research report" are intended to recognize these different forms of debt research and to accommodate the needs of the institutional market participants.

In a concept proposal published in Regulatory Notice 11-11[15], FINRA first sought to gather additional information on differences between debt and equity research and the most appropriate rules to protect recipients of debt research. FINRA subsequently

15 See Regulatory Notice 11-11 (March 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123296.pdf

published two rule proposals in Regulatory Notice 12-09 and Regulatory Notice 12-42, each refining the previous proposal in response to comments.

The proposed rule change reflects feedback from those proposals and extensive discussions with industry participants. This proposal is narrowly tailored to achieve the regulatory objective to foster objectivity and transparency in debt research, particularly for retail investors, and to provide more reliable and useful information for investors to make investment decisions.

The proposed rule change adopts a substantial portion of the equity research rules and their basic framework for debt research distributed to retail investors. The equity research rules have proven to be effective in mitigating conflicts of interest in the publication and distribution of equity research.[16] Notwithstanding the differences in the operation of the equity and debt markets noted above, FINRA believes that many of the conflicts of interest in the publication and distribution of equity research are also present in debt research. Therefore, FINRA believes it reasonable generally to apply the same standards to address these conflicts for recipients of debt research reports. Moreover, FINRA believes that both investors and firms' compliance systems would benefit from consistency between those rules.

As noted above, the proposed rule change adopts a tiered approach that, in general, would provide retail debt research recipients with extensive protections similar to those provided to recipients of equity research under current and proposed FINRA rules, with modifications to reflect the different nature and trading of debt securities. Proposed FINRA Rule 2242 would differ from FINRA's current equity research rules in

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[16] See supra notes 7 and 8.

three key respects.[17] First, the proposed rule change would delineate the prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel. These restrictions take into account the need to ration a debt research analyst's resources among the multitude of debt securities, the limitations on price discovery in the debt markets, and the need for trading personnel to perform credit risk analyses with respect to current and prospective inventory. Second, the proposed rule change would exempt debt research provided solely to institutional investors from many of the structural protections and prescriptive disclosure requirements that apply to research reports distributed to retail investors. FINRA believes that this tiered approach is appropriate as it recognizes the needs of institutional market participants who rely on timely market color, trading strategies and other communications from the trading desk. Third, in addition to the exemption for limited investment banking activity found in the current and proposed equity research rules, the proposed rule change has a similar additional exemption for limited principal trading activity. The proposed rule change, in general, would exempt members that engage in limited investment banking activity or those with limited principal trading activity and revenues generated from debt trading from the review, supervision, budget, and compensation provisions in the proposed rule related to investment banking activity or principal trading activity, respectively.

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[17] FINRA notes that the proposed rule change differs from the current equity rules in some other respects, including not incorporating the quiet periods and restrictions on pre-IPO share ownership. FINRA believes that the different nature and trading of debt securities, as discussed in detail above, does not necessitate the restrictions in the context of debt research. We further note that the quiet periods in the equity rules are mandated by Sarbanes-Oxley and that FINRA has proposed to reduce or eliminate those quiet periods, consistent with Sarbanes-Oxley, in the proposed equity rules.

Like the equity research rules, the proposed rule change is intended to foster objectivity and transparency in debt research and to provide investors with more reliable and useful information to make investment decisions. The proposed rule change is set forth in detail below.

Proposed FINRA Rule 2242

Definitions

The proposed rule change would adopt defined terms for purposes of proposed FINRA Rule 2242.[18] Most of the defined terms closely follow the defined terms for equity research in NASD Rule 2711, as amended by the equity research filing, with minor changes to reflect their application to debt research. The proposed definitions are set forth below.[19]

Under the proposed rule change, the term "debt research analyst" would mean an associated person who is primarily responsible for, and any associated person who reports directly or indirectly to a debt research analyst in connection with, the preparation of the substance of a debt research report, whether or not any such person has the job title of "research analyst."[20] The term "debt research analyst account" would mean any account in which a debt research analyst or member of the debt research analyst's household has a financial interest, or over which such analyst has discretion or control;

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18 See proposed FINRA Rule 2242(a) for all of the proposed defined terms.

19 The proposed rule change also adopts defined terms to implement the tiered structure of proposed FINRA Rule 2242, including the terms "qualified institutional buyer" or "QIB," which is part of the description of an institutional investor for purposes of the Rule, and "retail investor." A detailed discussion of these definitions and the tiered structure of the proposed rule is available at pages 90 through 96.

20 See proposed FINRA Rule 2242(a)(1).

provided, however, it would not include an investment company registered under the Investment Company Act over which the debt research analyst or a member of the debt research analyst's household has discretion or control, provided that the debt research analyst or member of a debt research analyst's household has no financial interest in such investment company, other than a performance or management fee. The term also would not include a "blind trust" account that is controlled by a person other than the debt research analyst or member of the debt research analyst's household where neither the debt research analyst nor a member of the debt research analyst's household knows of the account's investments or investment transactions.[21]

The proposed rule change would define the term "debt research report" as 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 communications that solely constitute an equity research report as defined in proposed Rule 2241(a)(11).[22] The proposed definition and exceptions noted below would generally align with the definition of

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21 See proposed FINRA Rule 2242(a)(2). The exclusion for a registered investment company over which a research analyst has discretion or control in the proposed definition mirrors proposed changes to the definition of "research analyst account" in the equity research rules.

22 See proposed FINRA Rule 2242(a)(3). The proposed rule change does not incorporate a proposed exclusion from the equity research rule's definition of "research report" of communications concerning open-end registered investment companies that are not listed or traded on an exchange ("mutual funds") because it is not necessary since mutual fund securities are equity securities under Section 3(a)(11) of the Exchange Act and therefore would not be captured by the proposed definition of "debt research report" in the proposed rule change.

"research report" in NASD Rule 2711, while incorporating aspects of the Regulation AC definition of "research report".[23]

Communications that constitute statutory prospectuses that are filed as part of the registration statement would not be included in the definition of a debt research report. In general, the term debt research report also would not include communications that are limited to the following, if they do not include an analysis of, or recommend or rate, individual debt securities or issuers:

- discussions of broad-based indices;
- commentaries on economic, political or market conditions;
- commentaries on or analyses of particular types of debt securities or characteristics of debt securities;
- technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price;
- recommendations regarding increasing or decreasing holdings in particular industries or sectors or types of debt securities; or
- notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent debt research report on the subject company that includes all current applicable disclosures required by the rule and that such debt research report does not contain

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23 In aligning the proposed definition with the Regulation AC definition of research report, the proposed definition differs in minor respects from the definition of "research report" in NASD Rule 2711. For example, the proposed definition of "debt research report" would apply to a communication that includes an analysis of a debt security or an issuer of a debt security, while the definition of "research report" in NASD Rule 2711 applies to an analysis of equity securities of individual companies or industries.

materially misleading disclosure, including disclosures that are outdated or no longer applicable.

The term debt research report also, in general, would not include the following communications, even if they include an analysis of an individual debt security or issuer and information reasonably sufficient upon which to base an investment decision:

- statistical summaries of multiple companies' financial data, including listings of current ratings that do not include an analysis of individual companies' data;
- an analysis prepared for a specific person or a limited group of fewer than 15 persons;
- periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual debt securities in the context of a fund's or account's past performance or the basis for previously made discretionary investment decisions; or
- internal communications that are not given to current or prospective customers.

The proposed rule change would define the term "debt security" as any "security" as defined in Section 3(a)(10) of the Exchange Act, except for any "equity security" as defined in Section 3(a)(11) of the Exchange Act, any "municipal security" as defined in Section 3(a)(29) of the Exchange Act, any "security-based swap" as defined in Section 3(a)(68) of the Exchange Act, and any "U.S. Treasury Security" as defined in paragraph (p) of FINRA Rule 6710.[24] The proposed definition excludes municipal securities, in part because of FINRA's jurisdictional limitations with respect to such securities. The proposed definition excludes security-based swaps given the nascent and evolving nature

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[24] See proposed FINRA Rule 2242(a)(4).

of security-based swap regulation.[25] However, FINRA intends to monitor regulatory developments with respect to security-based swaps and may determine to later include such securities in the definition of debt security.

The proposed rule change would define the term "debt trader" 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.[26]

The proposed rule change would provide that the term "independent third-party debt research report" means a third-party debt research report, in respect of which the person producing the report: (1) has no affiliation or business or contractual relationship with the distributing member or that member's affiliates that is reasonably likely to inform the content of its research reports; and (2) makes

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25 The Commission's rulemaking in the area of security-based swaps, pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), is ongoing. In June 2011, the Commission proposed rules addressing policies and procedures with respect to research and analysis for security-based swaps as part of its proposal governing business conduct standards for security-based swap dealers and major security-based swap participants. See Securities Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396 (July 18, 2011) (Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants). In June 2012, the Commission staff sought comment on a statement of general policy for the sequencing of compliance dates for rules applicable to security-based swaps. See Securities Exchange Act Release No. 67177 (June 11, 2012), 77 FR 35625 (June 14, 2012) (Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act). In May 2013, the Commission re-opened comment on the statement of general policy and on the outstanding rulemaking releases. The comment period was reopened until July 22, 2013. See Securities Exchange Act Release No. 69491 (May 1, 2013), 78 FR 30800 (May 23, 2013) (Reopening of Comment Periods for Certain Proposed Rulemaking Releases and Policy Statements Applicable to Security-Based Swaps).

26 See proposed FINRA Rule 2242(a)(5).

content determinations without any input from the distributing member or that member's affiliates.[27]

The proposed rule change would define the term "investment banking department" as any department or division, whether or not identified as such, that performs any investment banking service on behalf of a member.[28] The term "investment banking services" would include, without limitation, acting as an underwriter, participating in a selling group in an offering for the issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital or equity lines of credit or serving as placement agent for the issuer or otherwise acting in furtherance of a private offering of the issuer.[29]

The proposed rule change would define the term "member of a debt research analyst's household" as any individual whose principal residence is the same as the debt research analyst's principal residence.[30] This term would not include an unrelated person who shares the same residence as a debt research analyst, provided that the debt research analyst and unrelated person are financially independent of one another.

The proposed rule change would define "public appearance" as any participation

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27 See proposed FINRA Rule 2242(a)(6).

28 See proposed FINRA Rule 2242(a)(8).

29 See proposed FINRA Rule 2242(a)(9). The current definition in NASD Rule 2711 includes, without limitation, many common types of investment banking services. The proposed rule change and the equity research filing propose to add the language "or otherwise acting in furtherance of" either a public or private offering to further emphasize that the term "investment banking services" is meant to be construed broadly.

30 See proposed FINRA Rule 2242(a)(10).

in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons or before one or more representatives of the media, a radio, television or print media interview, or the writing of a print media article, in which a debt research analyst makes a recommendation or offers an opinion concerning a debt security or an issuer of a debt security.[31] This term shall not include a password protected webcast, conference call or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current debt research report or other documentation that contains the required applicable disclosures, and that the debt research analyst appearing at the event corrects and updates during the event any disclosures in the debt research report that are inaccurate, misleading or no longer applicable.

Under the proposed rule change the term "qualified institutional buyer" has the same meaning as under Rule 144A of the Securities Act.[32]

The proposed rule change would define "research department" as any department or division, whether or not identified as such, that is principally responsible for preparing the substance of a debt research report on behalf of a member.[33] The proposed rule change would define the term "subject company" as the company whose debt securities are the subject of a debt research report or a public appearance.[34] Finally, the proposed rule change would define the term "third-party debt research

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[31] See proposed FINRA Rule 2242(a)(11).

[32] See proposed FINRA Rule 2242(a)(12).

[33] See proposed FINRA Rule 2242(a)(14).

[34] See proposed FINRA Rule 2242(a)(15).

report" as a debt research report that is produced by a person or entity other than the member.[35]

Identifying and Managing Conflicts of Interest

Similar to the proposed equity research rules, the proposed rule change contains an overarching provision that would require members to establish, maintain and enforce written 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 persons outside of the research department, including investment banking, sales and trading and principal trading personnel, subject companies and customers.[36] The proposed rule change then sets forth minimum requirements for those written policies and procedures. These provisions set out the fundamental obligation for a member to establish and maintain a system to identify and mitigate conflicts to foster integrity and fairness in its debt research products and services. The provisions are also intended to require firms to be more proactive in identifying and managing conflicts as new research products, affiliations and distribution methods emerge. This approach allows for some flexibility to manage identified conflicts, with some specified prohibitions and restrictions where disclosure does not adequately mitigate them. Most of the minimum requirements have been experience tested and found effective in the equity research rules.

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35 See proposed FINRA Rule 2242(a)(16).

36 See proposed FINRA Rule 2242(b)(1).

In general, the proposed rule change adopts, with slight modifications, the structural safeguards that the Joint Report found effective to promote analyst independence and objective research in the equity research rules, but in the form of mandated policies and procedures with some baseline proscriptions.[37] FINRA believes this approach will impose less cost than a pure prescriptive approach by requiring members to adopt a compliance system that aligns with their particular structure, business model and philosophy. FINRA notes that the approach is consistent with FINRA's general supervision rule, which similarly provides firms flexibility to establish and maintain supervisory programs best suited to their business models, reasonably designed to achieve compliance with applicable federal securities law and regulations and FINRA rules.[38] The proposed rule change introduces a distinction between sales and trading

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[37] Among the structural safeguards, FINRA believes separation between investment banking and debt research, and between sales and trading and principal trading and debt research, is of particular importance. As such, while the proposed rule change does not mandate physical separation between the debt research department and the investment banking, sales and trading and principal trading departments (or other person who might seek to influence research analysts), FINRA would expect such physical separation except in extraordinary circumstances where the costs are unreasonable due to a firm's size and resource limitations. In those instances, a firm must implement written policies and procedures, including information barriers, to effectively achieve and monitor separation between debt research and investment banking, sales and trading and principal trading personnel.

[38] See NASD Rule 3010, recently adopted with changes as a consolidated FINRA rule by Securities Exchange Act Release No. 71179 (December 23, 2013), 78 FR 79542 (December 30, 2013) (Order Approving File No. SR-FINRA-2013-025). The consolidated rule becomes effective December 1, 2014. FINRA notes that the policies and procedures approach is consistent with the effective practices highlighted by FINRA in its Report on Conflicts of Interest, among them that firms should implement a robust conflicts management framework that includes structures, processes and policies to identify and manage conflicts of interest. See Report on Conflicts of Interest, FINRA (October 2013) at 5, available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf. The proposed changes also help to harmonize with approaches in

personnel—institutional sales representatives and sales traders—and persons engaged in principal trading activities, where the conflicts addressed by the proposal are of most concern.

Specifically, members must implement written policies and procedures reasonably designed to promote objective and reliable debt research that reflects the truly held opinions of debt research analysts and to prevent the use of debt research reports or debt research analysts to manipulate or condition the market or favor the interests of the firm or current or prospective customers or class of customers.[39] Such policies and procedures must, at a minimum, address the following.

Prepublication Review

The required policies and procedures must, at a minimum, be reasonably designed to prohibit prepublication review, clearance or approval of debt research by persons involved in investment banking, sales and trading or principal trading, and either restrict or prohibit such review, clearance and approval by other non-research personnel other than legal and compliance.[40] The policies and procedures also must prohibit

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international jurisdictions, such as the rules of the Financial Conduct Authority in the United Kingdom. See COBS 12.2.5 R, The Financial Conduct Authority Handbook, available at http://fshandbook.info/FS/html/handbook/COBS/12/2.

39 See proposed FINRA Rule 2242(b)(2).

40 See proposed FINRA Rule 2242(b)(2)(A) and (B). Thus, a firm must specify in its policies and procedures the circumstances, if any, where prepublication review would be permitted as necessary and appropriate pursuant to proposed FINRA Rule 2242(b)(2)(B); for example, where non-research personnel are best situated to verify select facts or where administrative personnel review for formatting. FINRA notes that members still would be subject to the overarching requirement to have policies and procedures reasonably designed to effectively manage conflicts of interest between research analysts and those outside of the research department. See also proposed FINRA Rule 2242.05 (Submission of Sections of a Draft Research Report for Factual Review).

prepublication review of a debt research report by a subject company, other than for verification of facts.[41] Similar provisions in the equity rules have proven effective to ensure independence of the research department, and FINRA believes that the objectivity of debt research could be compromised to the extent conflicted persons, e.g., those involved in investment banking and trading activities, have an opportunity to review and comment on the content of a debt research report. The proposed rule change would allow limited review by the subject company because it is sometimes in a unique position to verify facts; otherwise, FINRA believes research analysts should confirm that purported facts are based on other reliable information. The proposed rule change allows sections of a draft debt research report to be provided to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or to the subject company for factual review, so long as: (a) the sections of the draft debt research report submitted do not contain the research summary, recommendation or rating; (b) a complete draft of the debt research report is provided to legal or compliance personnel before sections of the report are submitted to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company; and (c) if, after submitting sections of the draft debt research report to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company, the research department intends to change the proposed rating or recommendation, it must first provide written justification to, and receive written authorization from, legal or

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41 See proposed FINRA Rule 2242(b)(2)(N).

compliance personnel for the change. The member must retain copies of any draft and the final version of such debt research report for three years after publication.[42]

Coverage Decisions

With respect to coverage decisions, a member's written policies and procedures must restrict or limit input by investment banking, sales and trading and principal trading personnel to ensure that research management independently makes all final decisions regarding the research coverage plan.[43] However, as discussed below, the provision does not preclude personnel from these or any other department from conveying customer interests and coverage needs, so long as final decisions regarding the coverage plan are made by research management. FINRA believes this provision strikes an appropriate balance by allowing input of customer interests in determining the allocation of limited research resources to a wide range of debt securities, while preserving the final decisions for research management.

Solicitation and Marketing of Investment Banking Transactions

A member's written policies and procedures also must, at a minimum, restrict or limit activities by debt research analysts that can reasonably be expected to compromise their objectivity.[44] This includes prohibiting participation in pitches and other solicitations of investment banking services transactions and road shows and other marketing on behalf of issuers related to such transactions. The proposed rule change adopts Supplementary Material that incorporates an existing FINRA interpretation for the

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[42] See proposed FINRA Rule 2242.05 (Submission of Sections of a Draft Research Report for Factual Review).

[43] See proposed FINRA Rule 2242(b)(2)(C).

[44] See proposed FINRA Rule 2242(b)(2)(L).

equity research rules that prohibits in pitch materials any information about a member's debt research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable debt research coverage.[45] By way of example, the Supplementary Material explains that FINRA would consider the publication in a pitch book or related materials of an analyst's industry ranking to imply the potential outcome of future research because of the manner in which such rankings are compiled. The Supplementary Material further notes that a member would be permitted to include in the pitch materials the fact of coverage and the name of the debt research analyst, since that information alone does not imply favorable coverage. FINRA notes that, consistent with existing guidance on the equity research rules, debt research analysts may listen to or view a live webcast of a transaction-related road show or other widely attended presentation by investment banking to investors or the sales force from a remote location, or another room if they are in the same location.[46]

The proposed rule change also would prohibit investment banking personnel from directing debt research analysts to engage in sales or marketing efforts related to an investment banking services transaction or any communication with a current or prospective customer about an investment banking services transaction.[47] In addition, the proposed rule change adopts Supplementary Material to provide that, consistent with this requirement, no debt research analyst may engage in any communication with a

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45 See proposed FINRA Rule 2242.01 (Efforts to Solicit Investment Banking Business).

46 See NASD Notice to Members 07-04 (January 2007) and NYSE Information Memo 07-11 (January 2007).

47 See proposed FINRA Rule 2242(b)(2)(M).

current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction.[48] FINRA believes that the presence of investment bankers or issuer management could compromise a debt research analyst's candor when talking to a current or prospective customer about a deal.

FINRA believes that the role of any research analyst, debt or equity, is to provide unbiased analysis of issuers and their securities for the benefit of investors, not to help win business for their firms or market transactions on behalf of issuers. FINRA believes the prohibitions in these provisions, which have been a cornerstone of the equity research rules, are equally important to mitigate significant conflicts between investment banking and debt research analysts.

Supervision

A member's written policies and procedures must limit the supervision of debt research analysts to persons not engaged in investment banking, sales and trading or principal trading activities.[49] In addition, they further must establish information barriers or other institutional safeguards to ensure that debt research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking services,

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48 See proposed FINRA Rule 2242.02(a) (Restrictions on Communications with Customers and Internal Personnel).

49 See proposed FINRA Rule 2242(b)(2)(D). The provision is substantively the same as current NASD Rule 2711(b)(1), a core structural separation requirement in the equity research rules that FINRA believes is essential to safeguarding analyst objectivity.

principal trading or sales and trading activities or others who might be biased in their judgment or supervision.[50]

The requirement for information barriers or other institutional safeguards to insulate research analysts from pressure is taken from Sarbanes-Oxley, which applies only to research reports on equity securities. FINRA believes this provision has equal application to debt research reports and that firms must not allow supervision or influence by anyone in the firm outside of the research department whose interests may be at odds with producing objective research. FINRA believes that independence for debt research analysts requires effective separation from those whose economic interests may be in conflict with the content of debt research. The proposed rule change furthers that separation by prohibiting oversight of debt research analysts by those involved in investment banking or trading activities.

Budget and Compensation

A member's written policies and procedures also must limit the determination of a firm's debt research department budget to senior management, excluding senior management engaged in investment banking or principal trading activities, and without regard to specific revenues or results derived from investment banking.[51] However, the proposed rule change would expressly permit all persons to provide input to senior management regarding the demand for and quality of debt research, including product trends and customer interests. It further would allow consideration by senior management of a firm's overall revenues and results in determining the debt research

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50 See proposed FINRA Rule 2242(b)(2)(H).

51 See proposed FINRA Rule 2242(b)(2)(E).

budget and allocation of expenses. FINRA believes the budget provisions strike a reasonable balance by prohibiting final budget determinations by those persons most conflicted, but allowing input from all persons and consideration of revenues other than investment banking to best allocate scarce budget resources.

With respect to compensation determinations, a member's written policies and procedures must prohibit compensation based on specific investment banking services or trading transactions or contributions to a firm's investment banking or principal trading activities and prohibit investment banking and principal trading personnel from input into the compensation of debt research analysts.[52] Further, the firm's written policies and procedures must require that the compensation of a debt research analyst who is primarily responsible for the substance of a research report be reviewed and approved at least annually by a committee that reports to a member's board of directors or, if the member has no board of directors, a senior executive officer of the member.[53] This committee may not have representation from investment banking personnel or persons engaged in principal trading activities and must consider the following factors when reviewing a debt research analyst's compensation, if applicable: the debt research analyst's individual performance, including the analyst's productivity and the quality of the debt research analyst's research; and the overall ratings received from customers and peers (independent of the member's investment banking department and persons engaged in principal trading activities) and other independent ratings services.

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[52] See proposed FINRA Rule 2242(b)(2)(D) and (F).

[53] See proposed FINRA Rule 2242(b)(2)(G).

Neither investment banking personnel nor persons engaged in principal trading activities may give input with respect to the compensation determination for debt research analysts. However, sales and trading personnel may give input to debt research management as part of the evaluation process in order to convey customer feedback, provided that final compensation determinations are made by research management, subject to review and approval by the compensation committee.[54] The committee, which may not have representation from investment banking or persons engaged in principal trading activities, must document the basis for each debt research analyst's compensation, including any input from sales and trading personnel.

The compensation provisions are similar to those that have proven effective in the equity research rules. However, the separation extends to not only investment banking, but also those engaged in principal trading activities, because such persons have the most pronounced conflict with respect to debt research. FINRA believes that the compensation determination is a key source of influence on the content of debt research reports and therefore it is important to require both separation from those who might influence research analysts and consideration of the quality of the research produced in making that determination.

Personal Trading Restrictions

Under the proposed rule change, a member's written policies and procedures must restrict or limit trading by a "debt research analyst account" in securities, derivatives and funds whose performance is materially dependent upon the performance of securities

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54 See proposed FINRA Rule 2242(b)(2)(D) and (G).

covered by the debt research analyst.[55] The procedures must ensure that those accounts, supervisors of debt research analysts and associated persons with the ability to influence the content of debt research reports do not benefit in their trading from knowledge of the content or timing of debt research reports before the intended recipients of such research have had a reasonable opportunity to act on the information in the report.[56] Furthermore, the procedures must generally prohibit a debt research analyst account from purchasing or selling any security or any option or derivative of such security in a manner inconsistent with the debt research analyst's most recently published recommendation, except that they may define circumstances of financial hardship (e.g., unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account) in which the firm will permit trading contrary to that recommendation. In determining whether a particular trade is contrary to an existing recommendation, firms may take into account the context of a given trade, including the extent of coverage of the subject security. While the proposed rule change does not include a recordkeeping requirement, FINRA expects members to evidence compliance with their policies and procedures and retain any related documentation in accordance with FINRA Rule 4511.

The proposed rule change includes Supplementary Material .10, which provides that FINRA would not consider a research analyst account to have traded in a manner

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55 See proposed FINRA Rule 2242(b)(2)(J).

56 See proposed FINRA Rule 2242.07 (Ability to Influence the Content of a Research Report) would provide that for the purposes of the rule, an associated person with the ability to influence the content of a debt research report is an associated person who, in the ordinary course of that person's duties, has the authority to review the debt research report and change that debt research report prior to publication or distribution.

inconsistent with a research analyst's recommendation where a member has instituted a policy that prohibits any research analyst from holding securities, or options on or derivatives of such securities, of the companies in the research analyst's coverage universe, provided that the member establishes a reasonable plan to liquidate such holdings consistent with the principles in paragraph (b)(2)(J)(i) and such plan is approved by the member's legal or compliance department.[57] This provision is intended to provide a mechanism by which a firm's analysts can divest their holdings to comply with a more restrictive personal trading policy without violating the trading against recommendation provision in circumstances where an analyst has, for example, a "buy" rating on a subject company or debt security.

FINRA believes these provisions will protect investors by prohibiting research analysts and those with an ability to influence the content of research reports, such as supervisors, from trading ahead of their customers based on knowledge that may move the market once made public. FINRA further believes the provisions, in general, will promote objective research by requiring consistency between personal trading by research analysts and recommendations to customers.

Retaliation and Promises of Favorable Research

A member's written policies and procedures must prohibit direct or indirect retaliation or threat of retaliation against debt research analysts by any employee of the firm for publishing research or making a public appearance that may adversely affect the member's current or prospective business interests.[58] FINRA believes it is essential to a

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[57] See proposed FINRA Rule 2242.10.

[58] See proposed FINRA Rule 2242(b)(2)(I). This provision is not intended to limit a member's authority to discipline or terminate a debt research analyst, in

research analyst's independence and objectivity that no person employed by the member that is in a position to retaliate or threaten to retaliate should be permitted to do so based on the content of a research report or public appearance. The policies and procedures also must prohibit explicit or implicit promises of favorable debt research, specific research content or a specific rating or recommendation as inducement for the receipt of business or compensation.[59] This provision is also key to preserving the integrity of debt research and the independence of debt research analysts, who otherwise may feel pressure to tailor the content of debt research to the business interests of the firm.

Joint Due Diligence with Investment Banking Personnel

The proposed rule change establishes a proscription with respect to joint due diligence activities – i.e., due diligence by the debt research analyst in the presence of investment banking department personnel – during a specified time period. Specifically, the proposed rule change states that FINRA interprets the overarching principle requiring members to, among other things, establish, maintain and enforce written policies and procedures that address the interaction between debt research analysts, banking and subject companies,[60] to prohibit the performance of joint due diligence prior to the selection of underwriters for the investment banking services transaction.[61] FINRA understands that in some instances, due diligence activities take place even before an

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accordance with the member's written policies and procedures, for any cause other than writing an adverse, negative, or otherwise unfavorable research report or for making similar comments during a public appearance.

59 See proposed FINRA Rule 2242(b)(2)(K).

60 See proposed FINRA Rule 2242(b)(1)(C).

61 See proposed FINRA Rule 2242.09 (Joint Due Diligence).

issuer has awarded the mandate to manage or co-manage an offering. There is heightened risk in those circumstances that investment bankers may pressure analysts to produce favorable research that may bolster the firm's bid to become an underwriter for the offering. Once the mandate has been awarded, FINRA believes joint due diligence may take place in accordance with appropriate written policies and procedures to guard against interactions to further the interests of the investment banking department. At that time, FINRA believes that the efficiencies of joint due diligence outweigh the risk of pressure on debt research analysts by investment banking.

Communications Between Debt Research Analysts and Trading Personnel

The proposed rule change delineates the prohibited and permissible interactions between debt research analysts and sales and trading and principal trading personnel. The proposed rule change would require members to establish, maintain and enforce written policies and procedures reasonably designed to prohibit sales and trading and principal trading personnel from attempting to influence a debt research analyst's opinions or views for the purpose of benefiting the trading position of the firm, a customer or a class of customers.[62] It would further prohibit debt research analysts from identifying or recommending specific potential trading transactions to sales and trading or principal trading personnel that are inconsistent with such debt research analyst's currently published debt research reports or from disclosing the timing of, or material investment conclusions in, a pending debt research report.[63] The communications prohibited under the proposed rule change are intended to prevent undue influence on

62 See proposed FINRA Rule 2242.03(a)(1) (Information Barriers between Research Analysts and Trading Desk Personnel).

63 See proposed FINRA Rule 2242.03(a)(2) (Information Barriers between Research Analysts and Trading Desk Personnel).

debt research analysts to generate or conform research to a firm's proprietary trading interests or those of particular customers. FINRA believes that these prohibitions are necessary to mitigate a significant conflict between firms and their customers.

However, FINRA understands that certain communications between debt research analysts and trading desk personnel are essential to the discharge of their functions, e.g., debt research analysts need to obtain from trading personnel information relevant to a valuation analysis and trading personnel need to obtain from debt research analysts information regarding the creditworthiness of an issuer. These departments also must communicate regarding coverage decisions, given the large number of debt instruments.

Therefore, the proposed rule change would permit sales and trading and principal trading personnel to communicate customers' interests to a debt research analyst, so long as the debt research analyst does not respond by publishing debt research for the purpose of benefiting the trading position of the firm, a customer or a class of customers.[64] In addition, debt research analysts may provide customized analysis, recommendations or trade ideas to sales and trading and principal trading personnel and customers, provided that any such communications are not inconsistent with the analyst's currently published or pending debt research, and that any subsequently published debt research is not for the purpose of benefiting the trading position of the firm, a customer or a class of customers.[65]

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64 See proposed FINRA Rule 2242.03(b)(1) (Information Barriers between Research Analysts and Trading Desk Personnel).

65 See proposed FINRA Rule 2242.03(b)(2) (Information Barriers between Research Analysts and Trading Desk Personnel).

The proposed rule change also would permit sales and trading and principal trading personnel to seek the views of debt research analysts regarding the creditworthiness of the issuer of a debt security and other information regarding an issuer of a debt security that is reasonably related to the price or performance of the debt security, so long as, with respect to any covered issuer, such information is consistent with the debt research analyst's published debt research report and consistent in nature with the types of communications that a debt research analyst might have with customers. In determining what is consistent with the debt research analyst's published debt research, a member may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the debt research analyst's published views.[66] Finally, debt research analysts may seek information from sales and trading and principal trading personnel regarding a particular debt instrument, current prices, spreads, liquidity and similar market information relevant to the debt research analyst's valuation of a particular debt security.[67]

The proposed rule change clarifies that communications between debt research analysts and sales and trading or principal trading personnel that are not related to sales and trading, principal trading or debt research activities may take place without restriction, unless otherwise prohibited.[68]

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[66] See proposed FINRA Rule 2242.03(b)(3) (Information Barriers between Research Analysts and Trading Desk Personnel).

[67] See proposed FINRA Rule 2242.03(b)(4) (Information Barriers between Research Analysts and Trading Desk Personnel).

[68] See proposed FINRA Rule 2242.03(c) (Information Barriers between Research Analysts and Trading Desk Personnel).

Restrictions on Communications with Customers and Internal Sales Personnel

The proposed rule change would apply standards to communications with customers and internal sales personnel. Any written or oral communication by a debt research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.[69]

Consistent with the prohibition on investment banking department personnel directly or indirectly directing a debt research analyst to engage in sales or marketing efforts related to an investment banking services transaction or directing a debt research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction, no debt research analyst may engage in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction. These provisions are intended to allow debt research analysts to educate investors and internal sales personnel about an investment banking transaction in fair and balanced manner, in a setting that promotes candor by the debt research analyst.[70]

Content and Disclosure in Debt Research Reports

The proposed rule change would, in general, adopt the disclosures in the equity research rule for debt research, with modifications to reflect the different characteristics

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[69] See proposed FINRA Rule 2242.02(b) (Restrictions on Communications with Customers and Internal Personnel).

[70] See proposed FINRA Rule 2242.02(a) (Restrictions on Communications with Customers and Internal Personnel).

of the debt market. As discussed above, the equity research rules are designed to provide investors with useful information on which to base their investment decisions. FINRA believes retail debt investors would benefit from similar disclosures applied to debt research reports. In addition, FINRA understands from industry participants that members have systems in place to track the disclosures required under the equity research rules that can be leveraged to meet the debt research disclosure requirements in the proposed rule change.

The proposed rule change would require members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in their debt research reports are based on reliable information.[71] FINRA has included this provision because it believes members should have policies and procedures to foster verification of facts and trustworthy research on which investors may rely. In addition, the policies and procedures must be reasonably designed to ensure that any recommendation or rating has a reasonable basis and is accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation or rating.[72] While there is no obligation to employ a rating system under the proposed rule, members that choose to employ a rating system must clearly define in each debt research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based. In addition, the definition of each rating must be consistent with its plain meaning.[73]

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71 See proposed FINRA Rule 2242(c)(1)(A).

72 See proposed FINRA Rule 2242(c)(1)(B).

73 See proposed FINRA Rule 2242(c)(2).

Consistent with the equity rules, irrespective of the rating system a member employs, a member must disclose, in each debt research report that includes a rating, the percentage of all debt securities rated by the member to which the member would assign a "buy," "hold" or "sell" rating.[74] In addition, a member must disclose in each debt research report the percentage of subject companies within each of the "buy," "hold" and "sell" categories for which the member has provided investment banking services within the previous 12 months.[75] All such information must be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the publication date of the debt research report is less than 15 calendar days after the most recent calendar quarter.[76]

If a debt research report contains a rating for a subject company's debt security and the member has assigned a rating to such debt security for at least one year, the debt research report must show each date on which a member has assigned a rating to the debt security and the rating assigned on such date. This information would be required for the period that the member has assigned any rating to the debt security or for a three-year period, whichever is shorter.[77] Unlike the equity research rules, the proposed rule change does not require those ratings to be plotted on a price chart because of limits on price transparency, including daily closing price information, with respect to many debt securities.

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[74] See proposed FINRA Rule 2242(c)(2)(A).

[75] See proposed FINRA Rule 2242(c)(2)(B).

[76] See proposed FINRA Rule 2242(c)(2)(C).

[77] See proposed FINRA Rule 2242(c)(3).

The proposed rule change would require[78] a member to disclose in any debt research report at the time of publication or distribution of the report:

- if the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, any option, right, warrant, future, long or short position), and the nature of such interest;
- if the debt research analyst has received compensation based upon (among other factors) the member's investment banking, sales and trading or principal trading revenues;
- if the member or any of its affiliates: managed or co-managed a public offering of securities for the subject company in the past 12 months; received compensation for investment banking services from the subject company in the past 12 months; or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;
- if, as of the end of the month immediately preceding the date of publication or distribution of a debt research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month), the member or its affiliates have received from the subject company any compensation for products or services other than investment banking services in the previous 12 months;[79]

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78 See proposed FINRA Rule 2242(c)(4).

79 See also discussion of proposed FINRA Rule 2242.04 (Disclosure of Compensation Received by Affiliates) below.

- if the subject company is, or over the 12-month period preceding the date of publication or distribution of the debt research report has been, a client of the member, and if so, the types of services provided to the issuer. Such services, if applicable, shall be identified as either investment banking services, non-investment banking securities-related services or non-securities services;
- if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report;[80]
- if the debt research analyst received any compensation from the subject company in the previous 12 months; and
- any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of the publication or distribution of a debt research report.[81]

The proposed rule change would incorporate a proposed amendment to the corresponding provision in the equity research rules that expands the existing "catch all" disclosure to require disclosure of material conflicts known not only by the research analyst, but also by any "associated person of the member with the ability to influence the content of a research report." In so doing, the proposed rule change would capture material conflicts of interest that, for example, only a supervisor or the head of research may be aware of. The "reason to know" standard would not impose a duty of inquiry on

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80 This provision is analogous to the equity research rule requirement to disclose market making activity.

81 For example, FINRA would consider it to be a material conflict of interest if the debt research analyst or a member of the debt research analyst's household serves as an officer, director or advisory board member of the subject company.

the debt research analyst or others who can influence the content of a debt research report. Rather, it would cover disclosure of those conflicts that should reasonably be discovered by those persons in the ordinary course of discharging their functions.

The proposed equity research rules include an additional disclosure if the member or its affiliates maintain a significant financial interest in the debt or equity of the subject company, including, at a minimum, if the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. FINRA did not include this provision in the proposed debt research rule because, unlike equity holdings, firms do not typically have systems to track ownership of debt securities. Moreover, the number and complexity of bonds, together with the fact that a firm may be both long and short different bonds of the same issuer, make it difficult to have real-time disclosure of a firm's credit exposure. Therefore, the proposed rule change only requires disclosure of firm ownership of debt securities in research reports or a public appearance to the extent those holdings constitute a material conflict of interest.[82] While the ownership of the equity securities of the subject company of a debt research report can constitute a conflict of interest for the member that publishes or distributes the research report, FINRA does not believe the conflict requires routine disclosure, even above some threshold of ownership. This is because the impact of a debt research report on the market for an equity security is more attenuated than that of an equity research report. In those circumstances where the impact is heightened – e.g., a debt research report asserting that a subject company may not be able to meet its debt service – disclosure could be captured by the material conflict of interest provision.

[82] See proposed FINRA Rules 2242(c)(4)(H) and (d)(1)(E).

The proposed rule change adopts from the equity research rules the general exception for disclosure that would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.[83] Similar to the equity research rules, the proposed rule change would require that disclosures be presented on the front page of debt research reports or the front page must refer to the page on which the disclosures are found. Electronic debt research reports, however, may provide a hyperlink directly to the required disclosures. All disclosures and references to disclosures required by the proposed rule must be clear, comprehensive and prominent.[84]

Like the equity research rule, the proposed rule change would permit a member that distributes a debt research report covering six or more companies (compendium report) to direct the reader in a clear manner to the applicable disclosures. Electronic compendium reports must include a hyperlink to the required disclosures. Paper-based compendium reports must provide either a toll-free number or a postal address to request the required disclosures and also may include a web address of the member where the disclosures can be found.[85]

Disclosure of Compensation Received by Affiliates

The proposed rule change would provide that a member may satisfy the disclosure requirement with respect to receipt of non-investment banking services compensation by an affiliate by implementing written policies and procedures reasonably designed to

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83 See proposed FINRA Rule 2242(c)(5).

84 See proposed FINRA Rule 2242(c)(6).

85 See proposed FINRA Rule 2242(c)(7).

prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the affiliate as to whether the affiliate received such compensation.[86] In addition, a member may satisfy the disclosure requirement with respect to the receipt of investment banking compensation from a foreign sovereign by a non-U.S. affiliate of the member by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the non-U.S. affiliate as to whether such non-U.S. affiliate received or expects to receive such compensation from the foreign sovereign. However, a member must disclose receipt of compensation by its affiliates from the subject company (including any foreign sovereign) in the past 12 months when the debt research analyst or an associated person with the ability to influence the content of a debt research report has actual knowledge that an affiliate received such compensation during that time period.

Disclosure in Public Appearances

The proposed rule change closely parallels the equity research rules with respect to disclosure in public appearances. Under the proposed rule, a debt research analyst must disclose in public appearances:[87]

- if the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, whether it consists of any option, right, warrant,

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86 See proposed FINRA Rule 2242.04 (Disclosure of Compensation Received by Affiliates).

87 See proposed FINRA Rule 2242(d)(1).

future, long or short position), and the nature of such interest;

- if, to the extent the debt research analyst knows or has reason to know, the member or any affiliate received any compensation from the subject company in the previous 12 months;
- if the debt research analyst received any compensation from the subject company in the previous 12 months;
- if, to the extent the debt research analyst knows or has reason to know, the subject company currently is, or during the 12-month period preceding the date of publication or distribution of the debt research report, was, a client of the member. In such cases, the debt research analyst also must disclose the types of services provided to the subject company, if known by the debt research analyst; or
- any other material conflict of interest of the debt research analyst or member that the debt research analyst knows or has reason to know at the time of the public appearance.

However, a member or debt research analyst will not be required to make any such disclosure to the extent it would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.[88] Unlike in debt research reports, the "catch all" disclosure requirement in public appearances applies only to a conflict of interest of the debt research analyst or member that the analyst knows or has reason to know at the time of the public appearance and does not extend to conflicts that an associated person with the

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[88] See proposed FINRA Rule 2242(d)(2).

ability to influence the content of a research report or public appearance knows or has reason to know. FINRA understands that supervisors typically do not have the opportunity to review and insist on changes to public appearances, many of which are extemporaneous in nature.

The proposed rule change would require members to maintain records of public appearances by debt research analysts sufficient to demonstrate compliance by those debt research analysts with the applicable disclosure requirements for public appearances. Such records must be maintained for at least three years from the date of the public appearance.[89]

Disclosure Required by Other Provisions

With respect to both research reports and public appearances, the proposed rule change would require that, in addition to the disclosures required under the proposed rule, members and debt research analysts must comply with all applicable disclosure provisions of FINRA Rule 2210 (Communications with the Public) and the federal securities laws.[90]

Distribution of Member Research Reports

The proposed rule change, like the proposed amendments to the equity research rules, codifies an existing interpretation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and provides additional guidance regarding selective – or tiered – dissemination of a firm’s debt research reports. The proposed rule change requires firms to establish, maintain and enforce written policies and procedures

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[89] See proposed FINRA Rule 2242(d)(3).

[90] See proposed FINRA Rule 2242(e).

reasonably designed to ensure that a debt research report is not distributed selectively to internal trading personnel or a particular customer or class of customers in advance of other customers that the member has previously determined are entitled to receive the debt research report.[91] The proposed rule change includes further guidance to explain that firms may provide different debt research products and services to different classes of customers, provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm discloses its research dissemination practices to all customers that receive a research product.[92]

A member, for example, may offer one debt research product for those with a long-term investment horizon ("investor research") and a different debt research product for those customers with a short-term investment horizon ("trading research"). These products may lead to different recommendations or ratings, provided that each is consistent with the meaning of the member's ratings system for each respective product. However, a member may not differentiate a debt research product based on the timing of receipt of a recommendation, rating or other potentially market moving information, nor may a member label a debt research product with substantially the same content as a different debt research product as a means to allow certain customers to trade in advance of other customers.

In addition, a member that provides different debt research products and services for certain customers must inform its other customers that its alternative debt research products and services may reach different conclusions or recommendations that could

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91 See proposed FINRA Rule 2242(f).

92 See proposed FINRA Rule 2242.06 (Distribution of Member Research Products).

impact the price of the debt security.[93] Thus, for example, a member that offers trading research must inform its investment research customers that its trading research product may contain different recommendations or ratings that could result in short-term price movements contrary to the recommendation in its investment research. FINRA understands, however, that customers may actually receive at different times research reports originally made available at the same time because of the mode of delivery elected by the customer eligible to receive such research services (e.g., in paper form versus electronic). However, members may not design or implement a distribution system intended to give a timing advantage to some customers over others. FINRA will read with interest comments as to whether a member should be required to disclose to its other customers when an alternative research product or service does, in fact, contain a recommendation contrary to the research product or service that those customers receive.

Distribution of Third-party Debt Research Reports

FINRA 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. Moreover, the proposed rule change would incorporate the current standards for third-party equity research, including the distinction between independent and non-independent third-party research with respect to the review and disclosure requirements. In addition, the proposed rule change adopts an expanded requirement in

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93 See proposed FINRA Rule 2242.06 (Distribution of Member Research Products). A member that distributes both institutional and retail debt research would be required to inform its retail customers of the existence of the institutional debt research product and, if applicable, that the product may contain different recommendations or ratings than its retail debt research product. This disclosure need not be in each retail debt research report; rather, a member may establish policies and procedures reasonably designed to inform retail investors of the existence and nature of the institutional debt research product.

the proposed equity research rules that requires members to disclose any other material conflict of interest that can reasonably be expected to have influenced the member's choice of a third-party research provider or the subject company of a third-party research report. FINRA believes that it is important that readers be made aware of any conflicts of interest present that may have influenced either the selection or content of third-party research disseminated to investors.

The proposed rule change would prohibit a member from distributing third-party debt research if it knows or has reason to know that such research is not objective or reliable.[94] FINRA believes that, where a member is distributing or "pushing-out" third-party debt research, the member must have written policies and procedures to vet the quality of the research producers. A member would satisfy the standard based on its actual knowledge and reasonable diligence; however, there would be no duty of inquiry to definitively establish that the third-party research is, in fact, objective and reliable.

In addition, the proposed rule change would require a member to establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party debt research report it distributes contains no untrue statement of material fact and is otherwise not false or misleading.[95] For the purpose of this requirement, a member's obligation to review a third-party debt research report extends to any untrue statement of material fact or any false or misleading information that should be known from reading the debt research report or is known based on information otherwise possessed by the member.

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94 See proposed FINRA Rule 2242(g)(1).

95 See proposed FINRA Rule 2242(g)(2).

The proposed rule change would require that a member accompany any third-party debt research report it distributes with, or provide a web address that directs a recipient to, disclosure of any material conflict of interest that can reasonably be expected to have influenced the choice of a third-party debt research report provider or the subject company of a third-party debt research report, including, at a minimum:

- if the member or any of its affiliates managed or co-managed a public offering of securities for the subject company in the past 12 months; received compensation for investment banking services from the subject company in the past 12 months; or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;
- if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report; and
- any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of the publication or distribution of a debt research report.[96]

The proposed rule change would not require members to review a third-party debt research report prior to distribution if such debt research report is an independent third-party debt research report.[97] For the purposes of the disclosure requirements for third-party research reports, a member shall not be considered to have distributed a third-party debt research report where the research is an independent third-party debt

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96 See proposed FINRA Rule 2242(g)(3).

97 See proposed FINRA Rule 2242(g)(4).

research report and made available by a member upon request, through a member-maintained website, or to a customer in connection with a solicited order in which the registered representative has informed the customer, during the solicitation, of the availability of independent debt research on the solicited debt security and the customer requests such independent debt research.[98]

The proposed rule would require that members ensure that third-party debt research reports are clearly labeled as such and that there is no confusion on the part of the recipient as to the person or entity that prepared the debt research reports.[99]

Obligations of Persons Associated with a Member

The proposed rule change clarifies the obligations of each associated person under those provisions of the proposed rule that require a member to restrict or prohibit certain conduct by establishing, maintaining and enforcing particular policies and procedures. Specifically, the proposed rule change provides that, consistent with FINRA Rule 0140, persons associated with a member must comply with such member's written policies and procedures as established pursuant to the proposed rule. Failure of an associated person to comply with such policies and procedures shall constitute a violation of the proposed rule.[100] In addition, consistent with Rule 0140, the proposed rule states in Supplementary Material .08 that it shall be a rule violation for an associated person to engage in the restricted or prohibited conduct to be addressed through the establishment, maintenance

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98 See proposed FINRA Rule 2242(g)(5).

99 See proposed FINRA Rule 2242(g)(6). This requirement codifies guidance in Notice to Members 04-18 (March 2004) related to equity research reports.

100 See proposed FINRA Rule 2242.08 (Obligations of Persons Associated with a Member).

and enforcement of written policies and procedures required by provisions of FINRA Rule 2242, including applicable Supplementary Material, that embed in the policies and procedures specific obligations on individuals. This Supplementary Material reflects FINRA's position that associated persons can be held liable for engaging in conduct that is proscribed by the member under FINRA rules. FINRA is clarifying this point in the Supplementary Material because the proposed rule change would adopt a policies and procedures approach to restricted and prohibited conduct with respect to research in place of specific proscriptions in the current equity research rules. Thus, for example, where the proposed rule requires a member to establish policies and procedures to prohibit debt research analyst participation in road shows, associated persons also are directly prohibited from engaging in such conduct, even where a member has failed to establish policies and procedures. FINRA believes that it is incumbent upon each associated person to familiarize themselves with the regulatory requirements applicable to his or her business and should not be able to avoid responsibility where minimum standards of conduct have been established for members.

Exemption for Members with Limited Investment Banking Activity

Similar to the equity research rules, the proposed rule change exempts from certain provisions regarding supervision and compensation of debt research analysts those members that over 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.[101] Specifically, members that meet those thresholds would be exempt from

[101] See proposed FINRA Rule 2242(h).

the requirement to establish, maintain and enforce policies and procedures that: prohibit prepublication review of debt research reports by investment banking personnel or other persons not directly responsible for the preparation, content or distribution of debt research reports (but not principal trading or sales and trading personnel, unless the member also qualifies for the limited principal trading activity exemption); restrict or limit investment banking personnel from input into coverage decisions; limit supervision of debt research analysts to persons not engaged in investment banking; limit determination of the research department budget to senior management, excluding senior management engaged in investment banking activities; require that compensation of a debt research analyst be approved by a compensation committee that may not have representation from investment banking personnel; and establish information barriers to insulate debt research analysts from the review or oversight by persons engaged in investment banking services or other persons who might be biased in their judgment or supervision.[102] However, the proposed rule would require that members with limited investment banking activity establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in investment banking services activities or other persons, including persons engaged in principal trading or principal sales and trading activities, who might be biased in their judgment or supervision.[103] FINRA believes that even where research analysts

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[102] See proposed FINRA Rule 2242(b)(2)(A)(i), (b)(2)(B), (b)(2)(C) (with respect to investment banking), (b)(2)(D)(i), (b)(2)(E) (with respect to investment banking), (b)(2)(G) and (b)(2)(H)(i) and (iii).

[103] For the purposes of proposed FINRA Rule 2242(h), the term "investment banking services transactions" includes the underwriting of both corporate debt and equity securities but not municipal securities.

need not be structurally separated from investment banking or other non-research personnel, they should not be subject to pressures that could compromise their independence and objectivity.

While small investment banks may need those who supervise debt research analysts under such circumstances also to be involved in the determination of those analysts' compensation, the proposal still prohibits these firms from compensating a debt research analyst based upon specific investment banking services transactions or contributions to a member's investment banking services activities. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to all of the requirements of proposed FINRA Rule 2242(b).

FINRA has found the thresholds in the current equity rule to be reasonable and appropriate: they reduce the challenges and costs of compliance for select provisions for those firms whose limited investment banking business significantly reduces the magnitude of conflicts that could impact investors. In addition, in the context of the equity rules, FINRA analyzed data to see if changing the magnitude of either or both thresholds – the number of transactions managed or co-managed or the amount of gross revenues generated from those transactions – yielded a more appropriate universe of exempted firms. FINRA reviewed and analyzed deal data for calendar years 2009 through 2011. FINRA reviewed firms that either managed or co-managed deals and earned underwriting revenues from those transactions during the review period. The analysis found that 155 of 317 such firms – or 49% – 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. For example, increasing both of the thresholds by 33% (to 40 transactions managed or co-managed and $20 million in gross revenues over a three-year period) would result in 18 additional exempted firms. As such, FINRA believes the current exemption produces a reasonable and appropriate universe of exempted firms. Since the exemption in the equity research rules relates to the same investment banking conflicts that debt research analysts face, FINRA believes the exemption, with its current thresholds, is equally reasonable and appropriate for the debt research rules.

Exemption for Limited Principal Trading Activity

FINRA believes it appropriate to provide an exemption from some provisions of the proposed rule that require separation of debt research from sales and trading and principal trading for firms whose limited principal trading operations results in an appreciably increased burden of compliance relative to the expected investor protection benefits. In general, FINRA believes that firms with modest potential principal trading profits pose lower risk of having sales and trading or principal trading personnel pressure debt analysts, provided other safeguards remain in place. The proposed rule change therefore includes an exemption from certain provisions regarding supervision and compensation of debt research analysts for members that engage in limited principal trading activity where: (1) in absolute value on an annual basis, the member's trading gains or losses on principal trades in debt securities are $15 million or less over the previous three years, on average per year; and (2) the member employs fewer than 10 debt traders; provided, however, such members must establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision.[104] Specifically, members that meet those thresholds would be exempt from the requirement to establish, maintain and enforce policies and procedures that: prohibit prepublication review of debt research reports by principal trading or sales and trading personnel or other persons not directly responsible for the preparation, content or distribution of debt research reports (but not investment banking personnel, unless the firm also qualifies for the limited investment banking activity exemption); restrict or limit principal trading or sales and trading personnel from input into coverage decisions; limit supervision of debt research analysts to persons not engaged in sales and trading or principal trading activities, including input into the compensation of debt research analysts; limit determination of the research department budget to senior management, excluding senior management engaged in principal trading activities; require that compensation of a debt research analyst be approved by a compensation committee that may not have representation from principal trading personnel; and establish information barriers to insulate debt research analysts from the review or oversight by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision.[105] As with the limited investment banking activity exemption, members still would be required to establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or

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104 See proposed FINRA Rule 2242(i).

105 See proposed FINRA Rule 2242(b)(2)(A)(ii) and (iii), (b)(2)(B), (b)(2)(C) (with respect to sales and trading and principal trading), (b)(2)(D)(ii) and (iii), (b)(2)(E) (with respect to principal trading), (b)(2)(G) and (b)(2)(H)(ii) and (iii).

sales and trading activities or other persons who might be biased in their judgment or supervision. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to all of the requirements of proposed FINRA Rule 2242(b).

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. 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 the assessment, FINRA believes 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. FINRA intends to monitor the research produced by firms that avail themselves of the exemption to assess whether the thresholds to qualify for the exemption are appropriate or should be modified.

Exemption for Debt Research Reports Provided to Institutional Investors

FINRA 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. FINRA 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 selectively incorporate research as a data point in their own analytics) and reaching pricing decisions. Moreover, some well-regarded debt research is produced by analysts that are part of the trading desk. The separation required by the Rule would preclude this source of information. Given the debt market and the needs of its participants, the proposed rule change would exempt debt research distributed solely to eligible institutional investors ("institutional debt research") from most of the provisions regarding supervision, coverage determinations, budget and compensation determinations and all of the disclosure requirements applicable to debt research reports distributed to retail investors ("retail debt research").[106] Under the proposed rule change, the term "retail investor" means any person other than an institutional investor.[107]

FINRA believes that institutional investors should opt in to receive institutional debt research and should be able to choose to receive only debt research that is subject to the full protections of the rule. The proposed rule distinguishes between larger and smaller institutions in the manner in which their opt-in decision is obtained. The larger may receive institutional debt research based on negative consent, while the smaller must affirmatively consent in writing to receive that research.

Specifically, the proposed rule would allow firms to distribute institutional debt research by negative consent to a person who meets the definition of a QIB[108] and where, pursuant to FINRA Rule 2111(b): (1) the member or associated person has a reasonable basis to believe that the QIB 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; and (2) the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the member's recommendations pursuant to FINRA Rule 2111 and such affirmation is broad enough to encompass

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[106] See proposed FINRA Rule 2242(j)(1).

[107] See proposed FINRA Rule 2242(a)(13).

[108] See proposed FINRA Rule 2242(a)(12) under which a QIB has the same meaning as under Rule 144A of the Securities Act.

transactions in debt securities. The proposed rule change would require written disclosure to the QIB that the member may provide debt research reports that are intended for institutional investors and are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors. If the QIB does not contact the member and request to receive only retail debt research reports, the member may reasonably conclude that the QIB has consented to receiving institutional debt research reports.[109] FINRA interprets this standard to allow an order placer, e.g., a registered investment adviser, for a QIB that satisfies the FINRA Rule 2111 institutional suitability requirements with respect to debt transactions to agree to receive institutional debt research on behalf of the QIB by negative consent.

Institutional accounts that meet the definition of FINRA Rule 4512(c) but do not satisfy the higher tier requirements described above may still affirmatively elect in writing to receive institutional debt research. Specifically, a person that meets the definition of "institutional account" in FINRA Rule 4512(c) may receive institutional debt research provided that such person, prior to receipt of a debt research report, has affirmatively notified the member in writing that it wishes to receive institutional debt research and forego treatment as a retail investor for the purposes of the proposed rule. Retail investors may not choose to receive institutional debt research.[110]

To avoid a disruption in the receipt of institutional debt research, the proposed rule change would allow firms to send institutional debt research to any FINRA Rule 4512(c) account, except a natural person, without affirmative or negative consent for a

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[109] See proposed FINRA Rule 2242(j)(1)(A)(i) and (ii).

[110] See proposed FINRA Rule 2242(j)(1)(B).

period of up to one year after SEC approval while they obtain the necessary consents. Natural persons that qualify as an institutional account under FINRA Rule 4512(c) must provide affirmative consent to receive institutional debt research during this transition period and thereafter.[111]

The proposed exemption relieves members that distribute institutional debt research to institutional investors from the requirements to have written policies and procedures for this research with respect to: (1) restricting or prohibiting prepublication review of institutional debt research by principal trading and sales and trading personnel or others outside the research department, other than investment banking personnel; (2) input by investment banking, principal trading and sales and trading into coverage decisions; (3) limiting supervision of debt research analysts to persons not engaged in investment banking, principal trading or sales and trading activities; (4) limiting determination of the debt research department's budget to senior management not engaged in investment banking or principal trading activities and without regard to specific revenues derived from investment banking; (5) determination of debt research analyst compensation; (6) restricting or limiting debt research analyst account trading; and (7) information barriers to ensure debt research analysts are insulated from review or oversight by investment banking, sales and trading or principal trading personnel, among others (but members still must have written policies and procedures to guard again those persons pressuring analysts). The exemption further would apply to all disclosure requirements, including content and disclosure requirements for third-party research.

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111 See proposed FINRA Rule 2242.11 (Distribution of Institutional Debt Research During Transition Period).

Notwithstanding the proposed exemption, some provisions of the proposed rule still would apply to institutional debt research, including the prohibition on prepublication review of debt research reports by investment banking personnel and the restrictions on such review by subject companies. While prepublication review by principal trading and sales and trading personnel would not be prohibited pursuant to the exemption, other provisions of the rule continue to require management of those conflicts, including the requirement to impose information barriers to insulate debt research analysts from pressure by those persons. Furthermore, the requirements in Supplementary Material .05 related to submission of sections of a draft debt research report for factual review would apply to any permitted prepublication review by persons not directly responsible for the preparation, content or distribution of debt research reports. In addition, members must prohibit debt research analysts from participating in the solicitation of investment banking services transactions, road shows and other marketing on behalf of issuers and further prohibit investment banking personnel from directly or indirectly directing a debt research analyst to engage in sales and marketing efforts related to an investment banking deal or to communicate with a current or prospective customer with respect to such transactions. The provisions regarding retaliation against debt research analysts and promises of favorable debt research also still apply with respect to research distributed to eligible institutional investors.[112] FINRA believes that, notwithstanding the sophistication of its recipients, minimum objectivity

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[112] See proposed FINRA Rule 2242(j)(2). A member must establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest described in paragraphs (b)(2)(A)(i), (b)(2)(H) (with respect to pressuring), (b)(2)(I), (b)(2)(K), (b)(2)(L), (b)(2)(M), (b)(2)(N) and Supplementary Material .02(a).

standards should apply to institutional debt research and members should not be encouraged to use debt research analysts for the purpose of soliciting and marketing investment banking transactions.

While the proposed rule change does not require institutional debt research to carry the specific disclosures applicable to retail debt research, it does require that such research carry general disclosures prominently on the first page warning that: (1) the report is intended only for institutional investors and does not carry all of the independence and disclosure standards of retail debt research reports; (2) if applicable, that the views in the report may differ from the views offered in retail debt research reports; and (3) if applicable, that the report may not be independent of the firm's proprietary interests and that the firm trades the securities covered in the report for its own account and on a discretionary basis on behalf of certain customers, and such trading interests may be contrary to the recommendation in the report.[113] Thus, the second and third disclosures described above would be required only if the member produces both retail and institutional debt research reports that sometimes differ in their views or if the member maintains a proprietary trading desk or trades on a discretionary basis on behalf of some customers and those interests sometimes are contrary to recommendations in institutional debt research reports. Although FINRA typically favors specific disclosure e.g., that a view or recommendation does, in fact, differ or is contrary to the member's

[113] See proposed FINRA Rule 2242(j)(3). With respect to the disclosure requirement, if applicable, that the views in the institutional debt research report may differ from views in retail debt research, FINRA notes institutional debt research is not subject to Supplementary Material .06, which otherwise requires a member to inform its customers of the existence of a different research product offered to other customers that may reach different conclusions or recommendations that could impact the price of the debt security.

trading interests – FINRA believes that the cost to track and identify a specific conflict with respect to institutional debt research reports exceeds the value that specific disclosure would provide to sophisticated institutional investors, particularly since those investors value timely analysis and trade ideas that could be diminished due to the burdens associated with a specific disclosure requirement.

FINRA believes that this approach will maintain the flow of institutional debt research to most institutional investors and allow firms to leverage existing compliance efforts, while ensuring that those investors who receive institutional debt research through negative consent have a high level of experience in evaluating transactions involving debt securities, and that certain protections remain in place to manage potential conflicts of interest. In addition, FINRA believes that this approach appropriately acknowledges the arm's-length nature of transactions between trading desk personnel and institutional buyers. Finally, FINRA notes that no institutional investor will be exposed to this less-protected institutional research without either negative or affirmative consent, as applicable.

The proposed rule change would require members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that institutional debt research is made available only to eligible institutional investors.[114] A member may not rely on the proposed exemption with respect to a debt research report that the member has reason to believe will be redistributed to a retail investor. The proposed rule change also states that the proposed exemption does not relieve a member of its obligations to comply with the antifraud provisions of the federal securities laws and

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[114] See proposed FINRA Rule 2242(j)(4).

FINRA rules.[115]

General Exemptive Authority

The proposed rule change would provide FINRA, pursuant to the FINRA Rule 9600 Series, with authority to conditionally or unconditionally grant, in exceptional and unusual circumstances, an exemption from any requirement of the proposed rule for good cause shown, after taking into account all relevant factors and provided that such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.[116] Given the scope of the rule's subject matter and the diversity of firm sizes, structures and research business and distribution models, FINRA believes it would be useful and appropriate to have the ability to provide relief from a particular provision of the proposed rules under specific factual circumstances.

As noted in Item 2 of this filing, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[117] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public

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115 See proposed FINRA Rule 2242(j)(5).

116 See proposed FINRA Rule 2242(k).

117 15 U.S.C. 78o-3(b)(6).

interest. FINRA believes that the proposed rule change would promote increased quality, objectivity and transparency of debt research distributed to investors by requiring firms to identify and mitigate conflicts in the preparation and distribution of such research. FINRA further believes the rule will provide investors with more reliable information on which to base investment decisions in debt securities, while maintaining timely flow of information important to institutional market participants and providing those institutional investors with appropriate safeguards.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule change largely adopts provisions that have proven effective to promote objective and reliable research in the equity research space, as detailed through academic studies and other observations in the Joint Report and the GAO Report.[118] The GAO report, for example, concluded that empirical studies suggest the rules have resulted in increased analyst independence and weakened the influence of conflicts of interest on analyst recommendations.[119]

The proposed rule change would adopt a policies and procedures approach that allows members to implement a compliance system that aligns with their particular structure and business models, without diminishing investor protection. FINRA believes that this proposed approach imposes less cost on members without reducing investor protections than does a purely prescriptive approach or "one size fits all" approach with

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118 See Joint Report, supra note 7 at 12-23.

119 See GAO Report, supra note 8 at 11-15.

respect to compliance. In addition, the proposed rule adopts a substantial portion of the equity research rules. FINRA believes that many of the same conflicts of interest are present in the publication and distribution of equity and debt research and that consistency among the debt and equity research rules will further minimize the burdens to members to comply with the proposed rule change.

As set forth in Item 5, FINRA elicited comment on proposed debt research rules in two separate Regulatory Notices. In each instance, FINRA carefully considered the commenters' concerns and amended the proposal to address issues with respect to costs and burdens raised by commenters. Even before the two proposals, FINRA issued a concept proposal in Regulatory Notice 11-11 to gather information and identify provisions of the equity research rules that would not be efficient or effective in a debt research proposal. For example, the concept proposal included a parallel provision to the equity rules that would have required a firm to promptly notify its customers if it intends to terminate coverage in a debt security and include with the notice a final research report. If it were impracticable to provide such final report, the concept proposal would have required a firm to disclose to customers its reason for terminating coverage. FINRA recognized that firms may have an extensive coverage universe of debt securities that may only be the subject of episodic research coverage. As such, FINRA determined that the termination of coverage provision in the debt context would be overly burdensome to firms relative to its investor protection value and therefore eliminated the provision from this revised proposal.

In addition, and as detailed below in Item 5, FINRA considered numerous iterations of an institutional exemption for debt research. Several commenters raised issues regarding an earlier provision that would have required affirmative consent for all institutional investors. In response to comments that the proposal was overly burdensome and may exclude a significant number of institutional investors from receiving the debt research that they receive today, FINRA is now proposing a higher tier of institutional investors that may receive institutional debt research based on negative consent. As set forth in Regulatory Notice 12-42, FINRA also made several other changes and clarifications in response to comments, including to the definition of "debt research report," the standard for disclosure of conflicts and the permissible interactions between debt research analysts and sales and trading personnel.

FINRA also considered an alternative suggested by commenters to exempt all trader commentary from the protections of the proposed rule. FINRA did not adopt this alternative because it would create an avenue through which firms could funnel debt research to retail investors without objectivity and reliability safeguards or disclosure of conflicts. FINRA reviewed examples of trader commentary and believes that many of those communications either do not meet the definition of a research report or are subject to exceptions from that definition. For those that are debt research reports, FINRA believes retail recipients should be entitled to the same protections, irrespective of the author or department of origin. FINRA further understands that most trader commentary is intended for sophisticated institutional investors, and to the extent a firm limits distribution to eligible institutional investors, most of the provisions of the proposed rule change would not apply. Therefore, FINRA believes its institutional exemption approach strikes the appropriate balance between protecting retail investors and maintaining timely information flow to more sophisticated investors.

FINRA also sought comment and engaged in data analysis, as described in Item 3, to fashion exemptions for firms with limited investment banking activity and limited principal trading activity. In combination with the institutional investor exemption, FINRA believes the proposed rule change is narrowly tailored to achieve its regulatory objectives.

Finally, FINRA notes that it solicited comment in Regulatory Notice 12-42 on the economic impact of the proposed rule change, including quantified costs and the anticipated effects on competition, but received little or no feedback.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Earlier iterations of the proposed rule change were published for comment in Regulatory Notice 12-09 ("Regulatory Notice 12-09 Proposal) and Regulatory Notice 12-42 ("Regulatory Notice 12-42 Proposal") (together, the "Notice Proposals"). Copies of the Regulatory Notices are attached as Exhibit 2a. A list of the commenters and copies of the comment letters received in response to the Notice Proposals are attached as Exhibits 2b and 2c, respectively.

The Regulatory Notice 12-09 Proposal sought comment on a proposed rule to govern the preparation and distribution of debt research pursuant to a tiered approach based on whether debt research is distributed to retail or institutional investors. Under the proposal, debt research distributed to retail investors would carry most of the same protections provided to recipients of equity research, while institutional investors could affirmatively opt in to a framework that would exempt such research from many of those provisions. FINRA received seven comments in response to the proposal.[120] Commenters suggested significant changes to the proposal, most notably with respect to the definitions of "debt security" and "debt research report," the opt-in requirement for institutional investors, and the restrictions on input into debt research budget and compensation determinations by those involved in principal trading activities.

FINRA addressed several of the commenters' concerns in the Regulatory Notice 12-42 Proposal, which included, among other things, amended exemptions for research distributed to certain institutional investors and for firms with limited principal debt trading activity. The amended exemption for institutional investors added a higher tier of institutional investor that could receive institutional debt research by negative consent. FINRA received five comment letters on the proposal.[121] The comments focused on two

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120 See Letter from Joseph R.V. Romano, President, Romano Brothers & Co., to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 31, 2012 ("Romano"); letter from Ryan K. Bakhtiari, President, Public Investors Arbitration Bar Association, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 2, 2012 ("PIABA"); letter from Ira D. Hammerman, Senior Managing Director, General Counsel and Secretary, Securities Industry and Financial Markets Association, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 2, 2012 ("SIFMA"); letter from Michael Nicholas, CEO, Bond Dealers of America, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 2, 2012 ("BDA"); letter from Lee A. Pickard and William D. Edick, Pickard and Djinis LLP, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 2, 2012 ("ASIR"); letter from Chris Charles, President, Wulff, Hansen & Co., to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 5, 2012 ("Wulff"); and letter from Amy Natterson Kroll, Bingham McCutchen LLP, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 10, 2012 ("Morgan Stanley").

121 See Letter from Kurt N. Schacht, Managing Director, and Linda L. Rittenhouse, Director, CFA Institute, to Marcia E. Asquith, Corporate Secretary, FINRA, dated December 7, 2012 ("CFA"); letter from Michael Nicholas, CEO, Bond Dealers of America, to Marcia E. Asquith, Corporate Secretary, FINRA, dated December 20, 2012 ("BDA"); letter from Lee A. Pickard and William D. Edick, Pickard and Djinis LLP, to Marcia E. Asquith, Corporate Secretary, FINRA, dated December 20, 2012 ("ASIR"); letter from Roberts J. Stracks, Counsel, BMO Capital Markets GKST Inc., to Marcia E. Asquith, Corporate Secretary, FINRA, dated

primary issues: the higher tier definition of institutional investor and the restrictions on input by principal trading personnel into research budget and evaluation and compensation determinations. Despite specific requests in the Regulatory Notice, FINRA received little or no comment on the economic impact of the proposal or any particular provisions.

A summary of the comments received on the Notice Proposals and FINRA's responses are set forth below.

Definitions

The Regulatory Notice 12-09 Proposal defined "debt security" to mean any "security" as defined in Section 3(a)(10) of the Exchange Act, except for any "equity security," "municipal security" or "security-based swap" as defined in Section 3(a) of the Exchange Act, or any U.S. Treasury Security as defined in FINRA Rule 6710(p). SIFMA and BDA urged FINRA to expand the exceptions to the definition to include U.S. agency securities and investment grade foreign government securities. BDA again urged FINRA to exclude U.S. agency securities in response to the Regulatory Notice 12-42 Proposal. SIFMA further asked FINRA to clarify that "derivatives," as defined in the CFTC conflict rules are excluded from the definition of "debt security" because they are subject to a separate federal regulatory regime. PIABA, on the other hand, thought FINRA should include municipal securities and security-based swaps within the definition.

December 20, 2012 ("BMO"); and letter from Kevin A. Zambrowicz, Managing Director, Associate General Counsel, Securities Industry and Financial Markets Association, to Marcia E. Asquith, Corporate Secretary, FINRA, dated January 4, 2013 ("SIFMA").

FINRA did not believe it was appropriate to expand the exceptions to the definition of "debt security" to include agency securities or foreign sovereign debt securities and did not propose these changes to the definition. FINRA has not provided these exclusions in the proposed rule change for a variety of reasons. First, commenters did not provide a rationale to exclude other non-equity securities. Second, treasury securities are excluded because FINRA is reticent to interfere with the markets involving direct obligations of the United States. In contrast, FINRA already has reporting schemes around agency securities and does not think it appropriate to carve out Fannie Mae and Freddie Mac securities, for example. Municipal securities were excluded from the proposal in part due to FINRA's jurisdictional limitations with respect to those securities, so suggestions to exclude other securities as analogous to municipals are misplaced.

FINRA believes an exclusion for foreign sovereign debt of other G-20 countries is too broad, as the conflicts the rules address are similarly present with respect to research on such securities, and therefore retail investors would benefit from the proposal's protections. Alternatively, commenters asked for greater flexibility with respect to disclosure of compensation on foreign sovereign issues, in large part due to tracking difficulties given the many and diverse relationships that firms' affiliates have with governments. In response, FINRA amended the proposal to permit firms, in lieu of disclosing investment banking compensation received by a non-U.S. affiliate from foreign sovereigns, to instead implement information barriers between that affiliate and the debt research department to prevent direct or indirect receipt of such information.[122] However, the proposed rule change would still require disclosure if the debt research

[122] See proposed FINRA Rule 2242. 04 (Disclosure of Compensation Received by Affiliates).

analyst has actual knowledge of receipt of investment banking compensation by the non-U.S. affiliate.

As stated in Item 3 above, the proposed rule excludes security-based swaps from the definition of debt security given the nascent and evolving nature of security-based swaps regulation. FINRA intends to monitor regulatory developments with respect to security-based swaps and may determine to later include such securities in the definition of debt security.

The Regulatory Notice 12-09 proposal defined "debt research report" as any written (including electronic) communication that includes an analysis of debt securities and that provides information sufficient upon which to base an investment decision. The term excluded the same communications excepted from the definition of "research report" in NASD Rule 2711. Morgan Stanley and SIFMA suggested that the definition should be amended to conform to the definition of "research report" in Regulation AC, which defines "research report" as a "written communication . . . that includes an analysis of a security or issuer . . . ." They further suggested that FINRA should include an exception from the definition of "research report" similar to interpretive guidance found in the Commission's adopting release about the general characteristics of that term as it is used in Regulation AC for "reports commenting on or analyzing particular types of debt securities or characteristics of debt securities" that do not include an analysis of, or recommend or rate individual securities or companies. In response to comments to both of the Notice Proposals, FINRA agreed that the definition of "debt research report" should be consistent with the definition in Regulation AC and therefore amended the proposal to achieve that regulatory harmony, including the exception for reports on classes of debt securities. This amendment is reflected in the proposed rule change.

In response to a suggestion by BDA to the Regulatory Notice 12-09 Proposal, FINRA included the exceptions to the definition of "debt research report" in the rule text rather than by reference to the exceptions in NASD Rule 2711. BDA, BMO, Morgan Stanley, SIFMA, and Wulff, in response to one or both of the Notice Proposals, suggested that FINRA should exclude from the definition desk communications, including trader commentary, if such communications are sent only to institutional investors. Among other arguments, these commenters asserted that trader commentary is common in the debt markets, that institutions don't rely on it as the sole basis for their investment decisions and that inclusion of trader commentary within the definition of "debt research report" is unduly burdensome and costly and could reduce available market information to investors without "commensurate policy returns." BDA asserted that the proposal would categorically eliminate an entire segment of analysis for retail investors without providing evidence that it is a harmful or abusive practice. In response to Regulatory Notice 12-42, BDA also stated that the definition should exclude offering documents for unregistered transactions and securities and any document prepared by or at the request of the issuer or obligor of a security.

FINRA continues to believe it imprudent to create a broad exception from the definition of "debt research report" based on the author or department of origin. As explained in Regulatory Notice 12-09, such an approach creates a potential loophole through which biased and non-transparent research could be disseminated to investors, including retail investors. FINRA notes that the Sarbanes-Oxley Act declined to adopt such an approach in the equity context. Furthermore, Regulation AC has no such exception, so the regulatory consistency that commenters seek would be undermined. If, as commenters maintain, trader commentary is mostly provided only to institutions, then the institutional research exemption could exclude these communications from most of the provisions of the rule that otherwise apply to retail debt research for institutions that opt in. While FINRA understands that institutions may be more attuned to conflicts, FINRA believes it appropriate that even institutional debt research should retain certain minimum standards of independence and transparency, including restrictions on prepublication review by investment banking and the issuer, prohibitions on promises of favorable research as an inducement for receipt of business or compensation and general disclosure alerting recipients of the lesser standards and potential conflicts of interest attendant to the research report.

FINRA declined BDA's suggestion to exclude from the definition of "debt research report" offering documents for unregistered transactions or any document prepared by or at the request of the issuer or obligor of a security. BDA offered no rationale for the exclusions, which would be inconsistent with Regulation AC. Moreover, FINRA believes an exception for any document requested by an issuer would seriously undermine the regulatory purpose of the proposed rule change because it would allow a broker-dealer to distribute to retail investors a communication that contains all of the elements of a debt research report but none of the protections where the issuer, a conflicted party, requested it be created.

Prepublication Review

The proposed rule change maintains provisions in the Notice Proposals that would prohibit prepublication review, clearance or approval of debt research reports by investment banking, principal trading and sales and trading personnel. In response to the Regulatory Notice 12-09 Proposal, SIFMA contended that the rule should permit investment banking and sales and trading to review debt research reports prior to publication for factual accuracy, subject to appropriate supervision. As an example, SIFMA cited research on new complex structured products, suggesting analysts need to verify with investment banking or sales and trading that the basic facts about the products are correct and to corroborate the accuracy of the analyst's statements regarding trading activity, prevailing market prices or yields. SIFMA also pointed out that current NASD Rule 2711 permits such factual review of research reports by investment banking and other non-research personnel.

First, FINRA notes that it has proposed to eliminate any prepublication review by investment banking or other persons not directly responsible for the preparation, content and distribution of equity research reports, other than legal and compliance personnel. FINRA believes that review of facts in a report by investment banking and other non-research personnel is unnecessary in light of the numerous other sources available to verify factual information, including the subject company. FINRA notes that such review may invite pressure on a research analyst that could be difficult to monitor. FINRA further notes that such factual review is not permitted under the terms of the Global

Settlement[123] and that FINRA staff has seen no evidence that the factual accuracy of research produced by Global Settlement firms has suffered. Second, with respect to debt research, the proposal delineates certain permissible communications between debt research analysts and sales and trading and principal trading personnel necessary for each to effectively discharge their responsibilities and facilitate debt market trading. Among the allowable communications, a debt research analyst may seek information from sales and trading and principal trading personnel regarding a "particular bond instrument, current prices, spreads, liquidity and similar market information relevant to the debt research analyst's valuation of a particular security." In light of these permissible communications, and the other reasons stated above, FINRA sees no compelling reason why a debt research analyst needs further factual review from sales and trading or principal trading personnel by sharing portions of a draft research report. FINRA believes that any incremental improvement in accuracy by permitting factual review by investment banking, principal trading or sales and trading personnel is outweighed by the increased risk of pressure on a research analyst and the prospect that the perceived objectivity of the research may be undermined. Therefore, the proposed rule change does not incorporate the commenter's suggestion.

Research Department Budget

The Regulatory Notice 12-09 Proposal limited determination of the research department budget to senior management, other than persons engaged in investment banking or principal trading activities, and without regard to specific revenues or results derived from those activities. However, the proposal noted that revenues and results of

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123 See Letter from James A. Brigagliano, Assistant Director, SEC Division of Trading and Markets, to Dana G. Fleischman, Clearly, Gottlieb, Steen & Hamilton, dated Nov. 2, 2004.

the firm as a whole may be considered in determining the debt research department budget and allocation of research department expenses. Moreover, the proposal permitted all persons within the firm to provide senior management input regarding the demand for and quality of debt research, including product trends and customer interests.

In response to that proposal, SIFMA commented that senior management should be permitted to consider principal trading and other business revenues in making budget decisions, else senior management cannot accurately marry research funding to customer needs. SIFMA further contended that the proposal's other provisions adequately safeguard against inappropriate pressures by investment banking and principal trading with respect to debt research budget determinations. The Regulatory Notice 12-42 Proposal maintained these restrictions on debt research budget input, and in response, SIFMA again asserted that the provision denies research management the ability to assess the value of the permissible input by comparing it to the revenues generated from principal trading activities, thereby resulting in a misallocation of resources. SIFMA contended that the allocation of the research department's resources to a particular asset class "will be and should be influenced by the size and profitability of the respective market."

FINRA appreciates the desire of firms to allocate research costs based on the revenues to which the research department contributes, but also sees a countervailing investor protection interest in firms managing conflicts between their revenue-producing operations and research. FINRA believes that the size and allocation of the research budget should be insulated from pressure by those business segments. In the case of investment banking, FINRA believes the conflict is too pronounced to allow any consideration of investment banking revenues in determining the research department budget. However, given the vast array of debt securities and classes, FINRA believes it appropriate to allow some consideration of revenue streams in allocating research budget resources. Therefore, the proposed rule change would permit consideration of those revenues, provided that: (1) senior management, other than persons engaged in principal trading or investment banking activities, makes the final research department budget determination;[124] and (2) the member establishes information barriers or other institutional safeguards to ensure that debt research analysts are insulated from the review, pressure or oversight by persons engaged in principal trading activities, among others.[125]

Debt Research Analyst Evaluation and Compensation

With respect to evaluation and compensation of debt research analysts, the proposed rule change maintains a provision in the Notice Proposals that would allow sales and trading personnel, but not persons engaged in principal trading activities, to provide input to research management into the evaluation of a debt research analyst, so long as research management makes final determinations on compensation, subject to review by the compensation committee.

In response to the Regulatory Notice 12-09 Proposal, SIFMA argued that the proposal was too strict in prohibiting the input of principal trading personnel and contributions to principal trading activities in determining debt research analyst compensation. SIFMA asserted that as long as final compensation decisions rest with

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[124] See proposed FINRA Rule 2242(b)(2)(E).

[125] See proposed FINRA Rule 2242(b)(2)(H).

research management and the compensation committee, FINRA should allow input from principal trading personnel because those individuals regularly interface with customers and therefore are a necessary resource for customer feedback on the quality and productivity of debt research analysts. SIFMA also noted that the provision would preclude input from persons who wear multiple hats and engage in both sales and principal trading activities. Finally, SIFMA contended that compensation prohibitions fail to acknowledge the important role that debt research analysts play in assisting market making and customer facilitation desks.

In response to Regulatory Notice 12-42, SIFMA reiterated that the provision will deprive research management of important client feedback to evaluate debt research analysts' performance because principal traders are the primary conduit for such information. According to SIFMA, there are limited means to obtain direct customer feedback on the quality of research, and reliance on the sales force to provide customer feedback is inadequate because debt traders can have as much or more interaction with clients. In addition, SIFMA noted that the CFTC business conduct rules permit employees of the business trading unit or clearing unit of a swap dealer or major swap participant to communicate customer feedback, ratings and other indicators of research analyst performance to research department management.[126]

While FINRA recognizes that there is some value in input from those engaged in principal trading activities, FINRA believes such input is outweighed by conflicts that

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[126] The CFTC rules apply to research on derivatives, which is predominantly an institutional business. As noted below, the proposed rule change exempts from the compensation prohibitions institutional debt research. By comparison, SIFMA asked to allow principal traders to relay customer feedback in connection with retail debt research.

could provide incentive for principal trading personnel to reward or punish a debt research analyst with selected feedback based on whether his or her research or trading ideas benefitted the firm's trading activities. Conversely, debt research analysts may feel compelled to produce research and trade ideas to benefit firm or particular customer positions if their compensation is tied to contributions to principal trading activities. Moreover, FINRA believes, in part based on discussions with research management personnel, that input from sales and trading personnel provides an effective proxy for customer feedback, to the extent such feedback cannot be obtained directly from customers. Furthermore, FINRA believes that research management should be in a position to assess the quality of the research it oversees. Finally, to the extent firms qualify for the limited principal trading exemption in the proposed rule change, dual-hatted persons engaged in both research and principal trading activities would be able to provide feedback to research department management.

Given the importance of principal trading operations to the revenues of many firms, FINRA believes there is increased risk that principal traders could improperly pressure or influence debt research if they have input into analyst compensation or can solicit, relay or characterize customer feedback on retail debt research. FINRA believes this risk, which if manifested could directly impact retail investors, outweighs the benefit of an additional data point for research management to evaluate the quality of research produced by analysts they oversee.

BDA stated that FINRA should amend the proposal to clarify that debt research analyst compensation may be based on the revenues and results of the firm as a whole. FINRA agrees that a member may consider the overall success of the firm when determining a debt analyst's compensation, provided the member complies with the compensation review and approval requirements. FINRA notes that the proposed rule change specifies that the revenues and results of the firm as a whole may be considered in determining the research department budget, including expenses. Since debt analyst compensation is a research department expense, FINRA does not believe it necessary to further amend the compensation provisions.

Prohibitions on Interactions with Investment Banking Personnel

The proposed rule change would require members to have written policies and procedures to prohibit participation in pitches and other solicitations of investment banking services transactions and participation in road shows and other marketing on behalf of an issuer related to investment banking services transactions.

The Regulatory Notice 12-09 Proposal had a similar provision, but did not limit the marketing prohibition to investment banking services transactions. SIFMA asked whether the proposed requirement with respect to road shows was intended to operate identically with NASD Rule 2711. SIFMA also asked FINRA to clarify that, consistent with NASD Rule 2711, the prohibition on road shows is only intended to cover road shows and other marketing related to an investment banking transaction and not non-deal road shows. FINRA is primarily concerned with marketing by research analysts in connection with an investment banking services transaction, and therefore FINRA has added that limitation to the provision in proposed rule change. FINRA notes, however, that the overarching requirement to have written policies and procedures to manage conflicts related to the interaction between debt research analysts and, among others, subject companies would apply to other marketing activity on behalf of an issuer.

FINRA does not believe that merely facilitating a meeting between issuer management and investors, absent other facts, would constitute marketing on behalf of the issuer.

In response to the Regulatory Notice 12-09 Proposal, SIFMA contended that the prohibition on joint due diligence conducted with the subject company in the presence of investment banking personnel was overly restrictive. FINRA has clarified in the proposed rule change that the prohibition on joint due diligence applies only during the period prior to the selection by the issuer of the underwriters for the investment banking services transaction.[127] In response to the Regulatory Notice 12-42 Proposal, SIFMA commented that debt research analysts should be able to passively attend road show presentations because, unlike equity analysts that frequently have access to issuer management, the road show is often the only opportunity for a debt research analyst to view an issuer's management presentation and evaluate the credibility of management's business plan and outlook. SIFMA contended that it is impractical for issuers to meet separately with debt research analysts and challenging for analysts to call in and listen to an issuer presentation. SIFMA also noted that the concern is more pronounced in certain sectors of the debt markets, such as high-yield and emerging markets.

FINRA does not believe that the prohibition with respect to road show participation should differ between the debt and equity research rules, since the conflicts are the same. FINRA believes the ability to listen remotely to a road show presentation provides debt research analysts a reasonable means to hear the issuer management's story, while not appearing to be part of the deal team to prospective customers attending the presentation in person. Therefore, FINRA did not amend this provision of the proposal.

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[127] See proposed FINRA Rule 2242.09 (Joint Due Diligence).

Prohibitions on Interactions with Sales and Trading

The proposed rule change maintains a provision in the Notice Proposals that would require members to have written policies and procedures to prohibit certain interactions between debt research and sales and trading and principal trading personnel. The proposed rule change also delineates prohibited and permissible communications between those persons. In response to the Regulatory Notice 12-09 Proposal, SIFMA asked FINRA to clarify that the prohibition on attempting to influence analysts for the purpose of benefiting the firm, a customer or class of customers would not capture ordinary-course communications and is meant to prohibit non-research direction over the decision to publish a report and non-research direction over the views and opinions expressed in debt reports. The proposed rule provides that communications between debt research analysts and trading desk personnel that are not related to sales and trading, principal trading or debt research activities may take place without restriction, unless otherwise prohibited.[128]

SIFMA also recommended that FINRA include in the proposed rule text the language provided in Regulatory Notice 12-09 that, in assessing whether a debt research analyst's permissible communications are "inconsistent" with the 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. FINRA incorporated the suggested language into proposed FINRA Rule 2242.[129]

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128 See proposed FINRA Rule 2242.03(c).

129 See proposed FINRA Rule 2242.03(b)(3).

ASIR noted that the Regulatory Notice 12-09 Proposal goes beyond NASD Rule 2711 by restricting not only communications between analysts and investment banking, but also between debt research analysts and sales and trading personnel. ASIR asserted that the debt research proposal should only restrict communications between research and investment banking personnel, so as to harmonize with the equity rules.

The proposed rule change specifically addresses communications between debt research and sales and trading and principal trading personnel because the interests of the trading department create a particularly pronounced conflict with respect to debt research. This is because, under current market conditions, principal trading is far more prevalent in the debt markets than in the equity markets. However, FINRA continues to monitor the relationship between equity research and sales and trading and principal trading personnel to assess whether similar specific restrictions should be applied in the equity research context. FINRA notes that the current and proposed equity research rules do require firms to manage conflicts between equity research and other non-research personnel, including those engaged in sales and trading and principal trading activities.

Conflicts Disclosure

With respect to the Regulatory Notice 12-09 Proposal, SIFMA and BDA found overly broad the provision that requires disclosure of "all conflicts that reasonably could be expected to influence the objectivity of the research report and that are known or should have been known by the member or debt research analyst on the date of publication or distribution of the report." SIFMA contended that the language would require firms to identify "all possible conflicts (material or immaterial)" and encouraged FINRA to either specify the conflicts it intends to capture or rely on the standard in

NASD Rule 2711 requiring disclosure of “actual, material” conflicts. SIMFA further questioned whether conflicts could ever be expected to influence the objectivity of research reports and suggested that existing FINRA research rules and Regulation AC assume the contrary.

In response to SIFMA’s doubt that conflicts could ever be expected to influence the objectivity of research reports, FINRA notes that its research rules are premised on the belief that conflicts can be disinfected – and possibly discouraged – by disclosure and will give investors the material information needed to assess the objectivity of a research report. In addition, the rules prohibit certain conduct where the conflicts are too pronounced to be cured by disclosure. Yet the rules do not – and cannot – identify every such conflict. Thus, at a minimum, FINRA’s proposal would require firms to identify and disclose them.

In general, FINRA believes that an immaterial conflict could not reasonably be expected to influence the objectivity of a research report, and therefore a materiality standard is essentially congruent with the proposed standard. FINRA agrees that the “catch-all” disclosure provision captures such material conflicts that the research analyst and persons with the ability to influence the content of a research report know or have reason to know. Therefore, FINRA has amended the proposal to delete as superfluous the overarching obligation to disclose “all conflicts that reasonably could be expected to influence the objectivity of the research report and that are known or should have been known by the member or research analyst on the date of publication or distribution of the report.”

SIFMA also contended that the requirement in proposed FINRA Rule 2242(c)(5) to disclose information on the date of publication or distribution is broader than current NASD Rule 2711, which only applies at the time of publication, and problematic logistically because the broader standard is not reflective of the conflicts that apply at the time the debt research analyst writes the research report. In addition, SIFMA argues that it is unclear how members could control and prevent the distribution of reports that have already been published in order to determine if additional disclosures are required. FINRA notes that the term "distribution" is drawn from the provisions of the Sarbanes-Oxley Law that apply to equity research reports and is intended to capture research that may only be distributed electronically as opposed to published in hard copy. FINRA has included the same "publication or distribution" language in the proposed changes to the equity research rules. However, FINRA interprets this language to require the disclosures to be current only as of the date of first publication or distribution, provided that the research report is prominently dated, and the disclosures are not known to be misleading.

The proposed rule text in the Regulatory Notice 12-09 Proposal required firms to ensure any recommendation or rating has a reasonable basis in fact and is accompanied by a clear explanation of the valuation method utilized and a fair presentation of the risks that may impede achievement of the recommendation or rating. SIFMA requested clarification that the requirement with respect to valuation method should apply only if the analyst used a "formal" valuation method. FINRA is not clear what constitutes a "formal" valuation method, but made a clarification in the proposed rule change to provide that any recommendation or rating must be accompanied by a clear explanation of "any" (as opposed to "the") valuation method used.

SIFMA also sought several other clarifications on the proposal. First, it asked FINRA to clarify that the requirement to include in research reports that contain a rating a distribution of "all securities rated by the member to which the member would assign a 'buy,' 'hold,' or 'sell' rating" is limited to debt securities. FINRA agrees that the proposed provision is limited to debt securities and has changed the text accordingly. Second, SIFMA sought flexibility to make a good faith determination as to which securities constitute a debt security that must be accompanied by a "ratings table," given that bonds of the same issuer may have different ratings. FINRA agrees that any ratings table should reflect ratings of distinct securities rather than issuers. Finally, SIFMA requested guidance to distinguish between a "recommendation" and a "rating" for the purposes of disclosure under the revised proposal. In particular, SIFMA suggested that a recommendation of a relative value or paired trade idea should constitute a recommendation but not a rating. While any determination will be fact specific, FINRA believes in general that a recommendation is a suggestion to make a particular investment while a rating is a label or conclusion attached to a research report.

SIFMA asked that FINRA allow firms to modify the required "health warning" disclosure for institutional debt research to refer to "this document" rather than "this research report" when the material is not prepared by research department personnel. While FINRA would permit firms to use the word "document" rather than "research report," such labeling must be used consistently and would have no bearing on whether the communication constitutes a "research report" for purposes of the proposed rule.

Third-Party Research Reports

With respect to distribution of third-party debt research reports, SIMFA objected to requirements in the Notice Proposals that do not currently apply to equity research under NASD Rule 2711. In particular, SIFMA cited the requirement to establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party debt research report it distributes is "reliable and objective." SIFMA stated that it is unclear what FINRA means by "objective." With respect to the requirement to disclose "any material conflict of interest that can reasonably expected to have influenced the choice of a third-party debt research provider or the subject company of a third-party debt research report," SIFMA stated that it is "not clear what types of conflicts this provision is intended to capture."

FINRA notes that its equity research proposal contains identical requirements with respect to the selection and distribution of third-party research. FINRA believes it reasonable to require firms to conduct upfront due diligence on the quality of its third-party research providers, particularly given the lesser review obligations imposed prior to distribution. FINRA notes that Global Settlement firms had to have such procedures to select their independent research providers,[130] and FINRA does not believe it unreasonable to have some type of screening procedures to ensure, for example that the third-party provider is not being paid by the issuer or that the research has some kind of track record or good reputation. In fact, in a 2006 comment letter, SIFMA stated that

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130 See Letter from James A. Brigagliano, Assistant Director, SEC Division of Trading and Markets, to Dana G. Fleischman, Clearly, Gottlieb, Steen & Hamilton, dated Nov. 2, 2004.

firms should "demand high standards" from providers of third-party research.[131] FINRA further believes it appropriate for firms to disclose to investors any relationship, e.g., an affiliate relationship, or other circumstances that rise to a material conflict of interest that could reasonably be seen as having influenced the choice of third-party research provider. FINRA believes this disclosure is consistent with the requirement to disclosure material conflicts of interest with respect to a firm's own research, and therefore will similarly promote objectivity and transparency of information provided to investors that may influence their investment decisions. FINRA notes that a firm may avoid the requirement to review third-party research for false or misleading statements if it chooses to distribute only independent third-party research.[132]

In response to the Notice Proposals, ASIR commented that the proposal could be read to impose obligations on members who make available third-party research pursuant to Section 28(e) of the Exchange Act to have procedures to ensure that such research is reliable and objective and labeled in a certain manner. FINRA is not proposing to make any changes based on this comment. However, research made available pursuant to Section 28(e) is not "distributed" and therefore the proposed requirements would not apply.

Institutional Investor Definition

The Regulatory Notice 12-09 proposal would have exempted from many of the rule's provisions debt research reports disseminated only to "institutional investors," provided that those institutional investors had, prior to receipt of a debt research report,

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131 See Letter from Michael D. Udoff, SIFMA, to Nancy M. Morris, Secretary, SEC, dated Nov. 14, 2006.

132 See proposed FINRA Rules 2242(g)(2) and (g)(4).

affirmatively notified the member in writing that they wished to forego treatment as a retail investor for the purposes of the rule. ASIR, BDA and SIFMA found this provision unnecessarily burdensome and difficult to implement and track. The commenters noted that they already expend resources to document similar consents under FINRA's suitability rule and that the nature of research distribution makes it more challenging than the suitability rule to track and process all eligible institutional investors that have consented to receive institutional debt research. Commenters instead advocated an approach whereby persons or entities that otherwise meet the definition of "institutional investor" – as defined in FINRA Rule 4512(c) – are presumed to have consented to the institutional debt research regime unless they affirmatively choose to receive the protections afforded recipients of retail debt research. Among other things, these commenters asserted that this alternative approach would be less costly and burdensome to administer and that the remaining protections afforded institutional debt research under the proposal, together with the content standards applicable to institutional communications pursuant to FINRA's Communications with the Public rules,[133] provide less sophisticated institutional investors adequate protections should they not to choose be treated as retail investors for the purposes of debt research.

After considering these comments and discussing the issue further with industry members, FINRA proposed a revised institutional investor exemption in the Regulatory Notice 12-42 Proposal. Under the revised proposal, institutional investors that meet the definition of QIB and satisfy the FINRA Rule 2111 institutional suitability standards with

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[133] At the time of the comment letters, those content standards were found in NASD IM-2110-1. Since that time, the Commission has approved a consolidated FINRA communications with the public rule, and those standards are now found in FINRA Rule 2210(d).

respect to debt trading and strategies would be eligible to receive institutional debt research by way of negative consent. Other institutional investors that meet the definition in FINRA Rule 4512(c) but do not satisfy the higher tier requirements could still affirmatively elect in writing to receive institutional debt research. The revised proposal asked whether alternative standards for the higher tier would be more appropriate, including one that combines the FINRA Rule 4512(c) definition and the institutional suitability requirements.

CFA Institute supported the revised higher tier of QIB plus suitability standard in Regulatory Notice 12-42. SIFMA, BDA and BMO opposed it. BDA asserted that all QIBs should be able to receive research on debt securities without consent since they are in the business of investing and that an institutional suitability standard should be imposed to determine whether other institutional accounts may receive institutional debt research. BMO expressed concern that the proposal to require affirmative consent is cumbersome and burdensome and would deprive some smaller and mid-size institutional investors of research they receive today, in part because experience has shown that some institutional clients cannot or will not provide the affirmation required in FINRA Rule 2111.

SIFMA contended that the proposal had both practical and logical flaws. SIFMA maintained that the QIB component would introduce a problematic new standard that would require complex and costly systems to track QIB certifications and link them to FINRA Rule 2111 certifications and research distribution lists. SIFMA stated that one firm estimated a cost of $5 million to develop such a system. SIFMA further noted that suitability certifications are tracked at the order placer level, whereas QIBs are tracked for particular transactions. SIFMA also asserted that the proposal would lead to anomalous results, such as the circumstance where a dual registered investment adviser has multiple institutional accounts, only some of which have QIB certificates. SIFMA asked how the registered investment adviser could meet its duty to all of its clients but only utilize the institutional debt research for the QIBs. SIFMA further questioned the logic of a proposal that would allow institutional investors to transact in restricted securities but not receive research on those securities without taking additional steps.

SIFMA offered two alternatives for the higher tier: (1) Non-natural persons that satisfy institutional suitability requirements with respect to debt trading and strategies; or (2) certain order placing institutions: QIBs; registered broker-dealers, banks, savings and loans, insurance companies, registered investment companies; registered investment advisers; institutions with $50-$100 million in assets and represented by an independent investment adviser; and universities, regulatory and government entities that use research for academic purposes.

FINRA does not believe that retail investors or less sophisticated institutional investors should be required to take any additional steps to receive the full protections of the proposed rule. FINRA believes that some QIBs may lack expertise and experience in debt market analysis and trading, including some employee benefit plans, trust funds with participants of employee benefit plans and charitable organizations. For the same reasons, FINRA believes SIFMA’s first alternative is too broad in that it would require less sophisticated institutional customers to affirmatively opt-in to the full protections of the rule. Therefore, the proposed rule change would adopt a standard under which firms may use negative consent only for the higher standard QIBs that also satisfy the institutional suitability requirements under FINRA Rule 2111 with respect to debt transactions, and affirmative consent from any institutional account as defined in FINRA Rule 4512(c). To avoid a disruption in the receipt of institutional debt research, the proposed rule change would allow firms to send institutional debt research to any FINRA Rule 4512(c) account, except a natural person, without affirmative or negative consent for a period of up to one year after SEC approval while they obtain the necessary consents. Natural persons that qualify as an institutional account under Rule 4512(c) must provide affirmative consent to receive institutional debt research during this transition period and thereafter.

FINRA believes that the proposed institutional investor definition strikes an appropriate balance between protecting less sophisticated institutional investors and maintaining the flow of research – and minimizing the burdens and costs of distributing debt research – to knowledgeable institutional investors. The exemption provides additional protections beyond the FINRA Rule 4512(c) standard for firms to receive institutional debt research by negative consent by ensuring that those institutions satisfy the higher QIB standard and are both capable of evaluating investment risks with respect to debt trading and strategies and have affirmatively indicated that they are exercising independent judgment in evaluating recommendations for such transactions. FINRA believes an affirmative consent requirement is appropriate for FINRA Rule 4512(c) accounts, which are more likely to include investors lacking experience in debt market analysis and trading. To the extent a FINRA Rule 4512(c) institutional investor values institutional debt research, FINRA believes the proposed rule change imposes a one-time small burden on such investors to provide written consent. Some firms indicated to

FINRA that the consent could be obtained at the time of other required written authorizations. FINRA believes the one-year grace period will ease the transition to the new rules without disrupting the current flow of debt research to institutional clients.

As to SIFMA's second alternative above, FINRA believes it would only exacerbate SIFMA's stated concerns about introducing a new standard, as the suggested standard has no precedent and is even more complex and presumably difficult to track than the QIB plus suitability standard FINRA proposes to adopt to receive institutional debt research by negative consent.

SIFMA also commented that even if FINRA adopted its preferred institutional suitability standard for the higher tier, many firms may not avail themselves of the exemption because of cost, logistics and obligations to provide their research to retail customers. Thus, SIFMA asked to narrow the scope of restricted persons by adopting the following definition of "principal trading" to mean:

> Engaging in proprietary trading activities for the trading book of a member but does not include transactions undertaken as part of underwriting related, market making related, or hedging activities, or otherwise on behalf of clients.

FINRA declined to adopt the suggested definition. FINRA believes the definition is overly broad and ambiguous and could encourage traders to pressure debt research analysts to support firm inventory positions. For example, the proposed definition would seem to permit traders of auction rate securities to participate in the determination of compensation for debt research analysts, thereby sanctioning the type of concerning conduct that served as a catalyst for rulemaking in this area. For the same reason, FINRA declines a request by BMO for FINRA to clarify that persons who position debt inventory to sell on a principal basis to customers but not for a firm's proprietary trading account would not be deemed to be engaged in principal trading activities.

SIFMA indicated to FINRA in discussions subsequent to their comment letter that firms with large institutional client bases were divided on whether the QIB-based negative consent standard or the FINRA Rule 4512(c) affirmative consent standard would be preferable from a cost efficiency perspective. The proposed rule change provides both options, which FINRA believes will help reduce the costs to satisfy the exemption requirements. The proposed rule change further reduces the costs of compliance by interpreting the QIB-based alternative to capture both QIBs and any order placer (e.g. registered investment adviser) that has at least one QIB sub-account. FINRA believes this interpretation addresses SIFMA's concern that suitability certifications are tracked at the order placer level, while QIBs are tracked for particular transactions, as well as concerns as to how the requirement would apply to a registered investment adviser with both QIB and non-QIB accounts. FINRA understands that the single $5 million estimate referenced by SIFMA in its letter was based in large part on the cost of developing a system that could directly link institutional suitability certifications to QIB sub-accounts and that the interpretation would appreciably reduce the burden.

Limited Investment Banking or Principal Trading Activities Exemptions

The proposed rule change includes an exemption for firms with limited investment banking activity, which is defined as managing or co-managing 10 or fewer investment banking services transactions on average per year over the previous three years and generating $5 million or less in gross investment banking revenues from those transactions. The proposed rule change also includes an exemption for firms that engage in limited principal trading activity where, in absolute value on an annual basis, the member's trading gains or losses on principal trades in debt securities are $15 million or less over the previous three years, on average per year, and the member employs fewer than 10 debt traders.

In response to Regulatory Notice 12-42, CFA opposed both the proposed exemption for firms with limited investment banking and the proposed exemption for firms with limited principal debt trading activities because they would allow influences that could compromise the independence and accuracy of debt research distributed to retail investors. FINRA did not propose any changes based on CFA's comments. With respect to the limited investment banking exemption, FINRA notes that this provision parallels an exemption in the equity research rules and FINRA has not found any evidence of abuse by firms subject to the exemption. With respect to the exemption for limited principal trading activity, FINRA notes that it would be limited to those firms whose limited trading activity makes the conflicts less pronounced and where it would be a significant marginal cost to add a trader dedicated to producing research.

In response to Regulatory Notice 12-09, Wulff and Romano expressed concerns regarding the exemption for firms that engage in limited investment banking activity, arguing that it did not go far enough to curtail the burden of the proposed rule on small firms, many of which have associated persons that engage in both producing debt research and principal trading activities, and that the thresholds were not appropriate for a proposal regarding debt research conflicts of interest. FINRA subsequently amended the proposal to add a more targeted exemption for firms with limited principal trading activity. The exemption, discussed in detail in Item 3, addresses the concerns of small firms with dual-hatted persons by exempting those firms that engage in modest principal trading activity from the restrictions on supervision and compensation determination of debt research analysts by those engaged in sales and trading and principal trading activities. As noted above, FINRA determined the thresholds for the exemption based on data analysis and a survey of firms that engage in principal trading activity.

In addition, FINRA maintained the exemption for firms with limited investment banking activity, exempting eligible firms from similar supervision and compensation determination restrictions with respect to investment banking personnel. FINRA also engaged in data analysis, discussed in Item 3, to confirm the appropriateness of the proposed thresholds for that exemption.

Effective Date

In response to both Regulatory Notices, SIFMA requested that FINRA establish an effective date that will provide adequate time for implementation of the proposed rule change, e.g., 12 to 18 months after SEC approval. FINRA notes that it will provide sufficient time for implementation taking into account any required systems changes.

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.[134]

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)

Not applicable.

[134] 15 U.S.C. 78s(b)(2).

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act

Not applicable.

10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Not applicable.

11. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. Regulatory Notice 12-09 (February 2012) and Regulatory Notice 12-42 (October 2012).

Exhibit 2b. List of commenters to Regulatory Notices 12-09 and 12-42.

Exhibit 2c. Commenter Letters received in response to Regulatory Notices 12-09 and 12-42.

Exhibit 3a. Regulatory Notice 11-11 (March 2011).

Exhibit 3b. Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules, December 2005.

Exhibit 5. Text of proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-   ; File No. SR-FINRA-2014-048)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on   , Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt new FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) to address conflicts of interest relating to the publication and distribution of debt research reports.

The text of the proposed rule change is available on FINRA's website at http://www.finra.org, at the principal office of FINRA and at the Commission's Public Reference Room.

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[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background

The proposed rule change would adopt FINRA Rule 2242 to address conflicts of interest relating to the publication and distribution of debt research reports. Proposed FINRA Rule 2242 would adopt a tiered approach that, in general, would provide retail debt research recipients with extensive protections similar to those provided to recipients of equity research under current and proposed FINRA rules, with modifications to reflect differences in the trading of debt securities.[3]

Currently, FINRA's research rules, NASD Rule 2711 (Research Analysts and Research Reports) and Incorporated NYSE Rule 472 (Communications with the Public) (the "equity research rules"), set forth requirements to foster objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions. The equity research rules apply only to research reports that

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[3] The proposed rule change reflects proposed amendments to FINRA's equity research rules set forth in a companion filing to the proposed rule change (the "equity research filing"). See SR-FINRA-2014-047.

include analysis of an "equity security," as that term is defined under the Exchange Act,[4] subject to certain exceptions.[5] The equity research rules were intended to restore public confidence in the objectivity of research and the veracity of research analysts, who are expected to function as unbiased intermediaries between issuers and the investors who buy and sell those issuers' securities.[6] The integrity of research had eroded due to the pervasive influences of investment banking and other conflicts during the market boom of the late 1990s.

In general, the equity research rules require disclosure of conflicts of interest in research reports and public appearances by research analysts. The equity research rules further prohibit conflicted conduct – investment banking personnel involvement in the content of research reports and determination of analyst compensation, for example – where the conflicts are too pronounced to be cured by disclosure. Several requirements in the equity research rules implement provisions of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which mandates separation between research and investment banking, proscribes conduct that could compromise a research analyst's objectivity and

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4 See 15 U.S.C. 78c(a)(11).

5 In contrast to FINRA's current research rules, SEC Regulation Analyst Certification ("Regulation AC"), the SEC's primary vehicle to foster objective and transparent research, applies to both debt and equity research. See 17 CFR 242.500 et seq.

6 NASD Rule 1050 (Registration of Research Analysts) and Incorporated NYSE Rule 344 (Research Analysts and Supervisory Analysts) require any person associated with a member and who functions as a research analyst to be registered as such and pass the Series 86 and 87 exams, unless an exemption applies. FINRA is considering whether debt research analysts also should be subject to the same or a similar qualification requirement.

requires specific disclosures in research reports and public appearances.[7] The Sarbanes-Oxley research provisions do not apply to debt research.

In December 2005, in response to a Commission Order, FINRA and NYSE Regulation, Inc. ("NYSE") submitted to the Commission a joint report on the operation and effectiveness of the research analyst conflict of interest rules (the "Joint Report").[8] Among other things, the Joint Report analyzed the impact of the equity research rules based on academic studies, media reports and commentary. The Joint Report concluded that the equity research rules have been effective in helping to restore integrity to research by minimizing the influence of investment banking and promoting transparency of other potential conflicts of interest. Evidence from academic studies, among other sources, further suggested that investors are benefiting from more balanced and accurate research to aid their investment decisions. A January 2012 GAO report on securities research ("GAO Report") also concluded that empirical studies suggest the rules have resulted in increased equity analyst independence and weakened the influence of conflicts of interest on analyst recommendations.[9]

The Joint Report also recommended changes to the equity research rules to strike a better balance between ensuring objective and reliable research on the one hand, and permitting the flow of information to investors and minimizing costs and burdens to

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7 15 U.S.C. 78o-6.

8 Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (December 2005), available at http://www.finra.org/web/groups/industry/@ip/@issues/@rar/documents/industry/p015803.pdf.

9 United States Government Accountability Office, Securities Research, Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest, January 2012.

members on the other.[10] The proposed rule change is informed by FINRA's experience with and the effectiveness of the equity research rules and incorporates many of the findings and recommendations from the Joint Report.

A number of events and circumstances contributed to FINRA's determination that a dedicated debt research rule is needed to further investor protection. In 2004, the Bond Market Association ("BMA") published its Guiding Principles to Promote the Integrity of Fixed Income Research ("Guiding Principles"),[11] a set of voluntary guidelines intended to foster management and transparency of conflicts of interest with respect to debt research. The Guiding Principles acknowledge that potential conflicts of interest could arise in the preparation of debt research, and many of the principles to maintain integrity of debt research hew closely to the equity research rule requirements. The Guiding Principles also reflect what the BMA asserted are several significant differences in the role and impact of research on the equity and fixed income markets, as well as differences in research regarding individual fixed-income asset classes. For example, the BMA contended that the prices of debt securities were less sensitive to the views of research analysts and that the major rating agencies provided a reliable source of independent information for the debt markets. It also asserted that most debt research was provided to sophisticated market participants for which it serves as one of many sources of information to consider when making an investment decision.

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10 The basis for the recommended changes to the equity research rules is described in more detail in the equity research filing. <u>See supra</u> note 3.

11 In 2005, the BMA merged with the Securities Industry Association ("SIA") to form the Securities Industry and Financial Markets Association ("SIFMA").

The Joint Report discussed the need for rules to govern debt research distribution. NASD and NYSE indicated that they would examine the extent to which firms voluntarily adopted the Guiding Principles and would consider further rulemaking after assessing the effectiveness of voluntary compliance. The Joint Report noted that the anti-fraud statutes and existing NASD and NYSE broad ethical rules could reach instances of misconduct involving debt research. NASD and NYSE subsequently surveyed a selection of firms' debt research supervisory systems and found many instances where firms failed to adhere to the Guiding Principles. More significantly, NASD and NYSE found cases where firms lacked any policies and procedures to manage debt research conflicts to ensure compliance with applicable ethical and anti-fraud rules. Those findings were published in Notice to Members 06-36,[12] where FINRA expressly noted that it would continue to consider more definitive rulemaking that might differ from or expand on the Guiding Principles.[13]

Following publication of its findings in 2006, FINRA continued to examine whether firms had implemented and enforced supervisory policies and procedures to promote the integrity of debt research and address attendant conflicts of interest. As noted in the GAO Report, between 2005 and 2010, FINRA conducted 55 such examinations and found deficiencies involving inadequate supervisory procedures to manage debt research conflicts or failure to disclose such conflicts in 11 (20%)

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12 Notice to Members 06-36 (July 2006).

13 As noted in the 2005 report, FINRA believes that the anti-fraud statutes, as well as existing FINRA rules, such as the requirement in FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) that members, in the conduct of their business, "observe high standards of commercial honor and just and equitable principles of trade," can reach any egregious conduct involving fixed-income research.

examinations. The GAO Report stated that most market participants and observers that the GAO interviewed "acknowledged that additional rulemaking is needed to protect investors, particularly retail investors." The GAO Report concluded that "until FINRA adopts a fixed-income research rule, investors continue to face a potential risk."

Following the consolidation of NASD and the member regulatory functions of NYSE Regulation, Inc. into FINRA, and as part of the process to develop the consolidated FINRA rulebook,[14] FINRA conducted a comprehensive review of all of its research rules and considered the appropriateness of adopting a dedicated rule to address potential conflicts of interest in the publication and distribution of debt research reports. In addition to its examination findings, and later, the conclusions of the GAO Report, several other factors also weighed in FINRA's decision to propose dedicated debt research conflict of interest rules. Misconduct in the sale of auction rate securities (i.e., debt traders pressured research analysts to help prop up the market with optimistic research) demonstrates that potential conflicts of interest in the publication and distribution of debt research can exist just as they do for equity research.[15] Also, the reliability of credit agency ratings was called into question during the financial crisis that

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14 The current FINRA rulebook includes, in addition to FINRA Rules, (1) NASD Rules and (2) rules incorporated from NYSE ("Incorporated NYSE Rules") (together, the NASD Rules and Incorporated NYSE Rules are referred to as the "Transitional Rulebook"). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE ("Dual Members"). For more information about the rulebook consolidation process, see Information Notice, March 12, 2008 (Rulebook Consolidation Process).

15 See e.g., SEC Finalizes ARS Settlements With Bank of America, RBC and Deutsch Bank, Litigation Release No. 21066, 2009 SEC LEXIS 1799 (June 3, 2009); SEC Finalizes ARS Settlement With Wachovia, Litigation Release No. 20885, 2009 SEC LEXIS 282 (February 5, 2009); SEC Finalizes Settlements With Citigroup and UBS, Litigation Release No. 20824, 2008 WL 5189517 (December 11, 2008).

began in 2008. Furthermore, the Dodd-Frank legislation in response to that crisis has resulted in rules by the Commodity Futures Trading Commission ("CFTC") to govern conflicts of interest regarding non-security-based swaps and commodities research, and the SEC has proposed rules that would require security-based swap dealers and major security-based swap participants to adopt written policies and procedures to address conflicts related to security-based swaps and research. Based on the foregoing considerations, and consistent with the regulatory trend to require mitigation and transparency of conflicts related to all types of investment research, FINRA believes it necessary and appropriate to provide better protections to recipients of debt research, particularly less sophisticated investors. FINRA's belief is buttressed by observations of retail investment in debt securities. For example, FINRA TRACE data shows that from 2007 through 2013, retail-sized transactions (defined to mean trades with a face value of less than $100,000) in corporate bonds increased approximately 97 percent to about 16,000 daily trades.

In developing the proposed rule change, FINRA recognized that the debt markets operate differently from the equity markets in some respects. Several of the differences were noted by the BMA in the release accompanying the Guiding Principles. For example, the debt markets feature a number of different asset classes (e.g., corporate, high yield, mortgage backed and asset-backed) with unique characteristics. Within each class, there are typically many issues with similar terms, creating a fungibility of securities that doesn't exist to the same extent in the equity markets. As the BMA noted, these securities are often priced in relation to benchmark securities or interest rate measures, and their prices tend to depend more on interest rate movements and other macroeconomic factors than issuer fundamentals, although an issuer's ability to service its debt remains an important factor. As a result of these dynamics, it is less likely that a debt research report will influence the price of a subject company's debt securities than an equity report will impact the price of that company's equity securities. Also, while retail and institutional market participants invest in both equity and debt securities, relative to the equity markets, the debt markets are dominated by institutional market participants.

The nature of the debt markets has resulted in several different types of debt research. There is debt research that focuses on the creditworthiness of an issuer or its individual debt securities. Debt research reports on individual debt securities may look at the relative value of those securities compared to similar securities of other issuers. Some debt research compares debt asset classes or issues within those asset classes. And in light of the importance of interest rates on the price of debt securities, much of the research related to debt analyzes macroeconomic factors, monetary policy and economic events without reference to particular assets classes or securities. While much of this research is prepared by a dedicated research department, FINRA also understands that trading desks generate market color, analysis and trading ideas, sometimes known as "trader commentary," geared towards institutional customers. FINRA understands from those participants that they value timely information from the trading desk and incorporate that information into their own analysis when making an investment decision about debt securities. As discussed in more detail below, the tiered structure of the proposed rule change and the definition of "debt research report" are intended to recognize these different forms of debt research and to accommodate the needs of the institutional market participants.

In a concept proposal published in Regulatory Notice 11-11[16], FINRA first sought to gather additional information on differences between debt and equity research and the most appropriate rules to protect recipients of debt research. FINRA subsequently published two rule proposals in Regulatory Notice 12-09 and Regulatory Notice 12-42, each refining the previous proposal in response to comments.

The proposed rule change reflects feedback from those proposals and extensive discussions with industry participants. This proposal is narrowly tailored to achieve the regulatory objective to foster objectivity and transparency in debt research, particularly for retail investors, and to provide more reliable and useful information for investors to make investment decisions.

The proposed rule change adopts a substantial portion of the equity research rules and their basic framework for debt research distributed to retail investors. The equity research rules have proven to be effective in mitigating conflicts of interest in the publication and distribution of equity research.[17] Notwithstanding the differences in the operation of the equity and debt markets noted above, FINRA believes that many of the conflicts of interest in the publication and distribution of equity research are also present in debt research. Therefore, FINRA believes it reasonable generally to apply the same standards to address these conflicts for recipients of debt research reports. Moreover,

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16 See Regulatory Notice 11-11 (March 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123296.pdf

17 See supra notes 8 and 9.

FINRA believes that both investors and firms' compliance systems would benefit from consistency between those rules.

As noted above, the proposed rule change adopts a tiered approach that, in general, would provide retail debt research recipients with extensive protections similar to those provided to recipients of equity research under current and proposed FINRA rules, with modifications to reflect the different nature and trading of debt securities. Proposed FINRA Rule 2242 would differ from FINRA's current equity research rules in three key respects.[18] First, the proposed rule change would delineate the prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel. These restrictions take into account the need to ration a debt research analyst's resources among the multitude of debt securities, the limitations on price discovery in the debt markets, and the need for trading personnel to perform credit risk analyses with respect to current and prospective inventory. Second, the proposed rule change would exempt debt research provided solely to institutional investors from many of the structural protections and prescriptive disclosure requirements that apply to research reports distributed to retail investors. FINRA believes that this tiered approach is appropriate as it recognizes the needs of institutional market participants who rely on timely market color, trading strategies and other communications from the trading desk. Third, in addition to the exemption for limited investment banking activity found in the

[18] FINRA notes that the proposed rule change differs from the current equity rules in some other respects, including not incorporating the quiet periods and restrictions on pre-IPO share ownership. FINRA believes that the different nature and trading of debt securities, as discussed in detail above, does not necessitate the restrictions in the context of debt research. We further note that the quiet periods in the equity rules are mandated by Sarbanes-Oxley and that FINRA has proposed to reduce or eliminate those quiet periods, consistent with Sarbanes-Oxley, in the proposed equity rules.

current and proposed equity research rules, the proposed rule change has a similar additional exemption for limited principal trading activity. The proposed rule change, in general, would exempt members that engage in limited investment banking activity or those with limited principal trading activity and revenues generated from debt trading from the review, supervision, budget, and compensation provisions in the proposed rule related to investment banking activity or principal trading activity, respectively.

Like the equity research rules, the proposed rule change is intended to foster objectivity and transparency in debt research and to provide investors with more reliable and useful information to make investment decisions. The proposed rule change is set forth in detail below.

Proposed FINRA Rule 2242

Definitions

The proposed rule change would adopt defined terms for purposes of proposed FINRA Rule 2242.[19] Most of the defined terms closely follow the defined terms for equity research in NASD Rule 2711, as amended by the equity research filing, with minor changes to reflect their application to debt research. The proposed definitions are set forth below.[20]

Under the proposed rule change, the term "debt research analyst" would mean an associated person who is primarily responsible for, and any associated person who

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19 See proposed FINRA Rule 2242(a) for all of the proposed defined terms.

20 The proposed rule change also adopts defined terms to implement the tiered structure of proposed FINRA Rule 2242, including the terms "qualified institutional buyer" or "QIB," which is part of the description of an institutional investor for purposes of the Rule, and "retail investor." A detailed discussion of these definitions and the tiered structure of the proposed rule is available at pages 188 through 194.

reports directly or indirectly to a debt research analyst in connection with, the preparation of the substance of a debt research report, whether or not any such person has the job title of "research analyst."[21] The term "debt research analyst account" would mean any account in which a debt research analyst or member of the debt research analyst's household has a financial interest, or over which such analyst has discretion or control; provided, however, it would not include an investment company registered under the Investment Company Act over which the debt research analyst or a member of the debt research analyst's household has discretion or control, provided that the debt research analyst or member of a debt research analyst's household has no financial interest in such investment company, other than a performance or management fee. The term also would not include a "blind trust" account that is controlled by a person other than the debt research analyst or member of the debt research analyst's household where neither the debt research analyst nor a member of the debt research analyst's household knows of the account's investments or investment transactions.[22]

The proposed rule change would define the term "debt research report" as 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 communications that solely constitute an

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21 See proposed FINRA Rule 2242(a)(1).

22 See proposed FINRA Rule 2242(a)(2). The exclusion for a registered investment company over which a research analyst has discretion or control in the proposed definition mirrors proposed changes to the definition of "research analyst account" in the equity research rules.

equity research report as defined in proposed Rule 2241(a)(11).[23] The proposed definition and exceptions noted below would generally align with the definition of "research report" in NASD Rule 2711, while incorporating aspects of the Regulation AC definition of "research report".[24]

Communications that constitute statutory prospectuses that are filed as part of the registration statement would not be included in the definition of a debt research report. In general, the term debt research report also would not include communications that are limited to the following, if they do not include an analysis of, or recommend or rate, individual debt securities or issuers:

- discussions of broad-based indices;
- commentaries on economic, political or market conditions;
- commentaries on or analyses of particular types of debt securities or characteristics of debt securities;
- technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price;

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23 See proposed FINRA Rule 2242(a)(3). The proposed rule change does not incorporate a proposed exclusion from the equity research rule's definition of "research report" of communications concerning open-end registered investment companies that are not listed or traded on an exchange ("mutual funds") because it is not necessary since mutual fund securities are equity securities under Section 3(a)(11) of the Exchange Act and therefore would not be captured by the proposed definition of "debt research report" in the proposed rule change.

24 In aligning the proposed definition with the Regulation AC definition of research report, the proposed definition differs in minor respects from the definition of "research report" in NASD Rule 2711. For example, the proposed definition of "debt research report" would apply to a communication that includes an analysis of a debt security or an issuer of a debt security, while the definition of "research report" in NASD Rule 2711 applies to an analysis of equity securities of individual companies or industries.

- recommendations regarding increasing or decreasing holdings in particular industries or sectors or types of debt securities; or
- notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent debt research report on the subject company that includes all current applicable disclosures required by the rule and that such debt research report does not contain materially misleading disclosure, including disclosures that are outdated or no longer applicable.

The term debt research report also, in general, would not include the following communications, even if they include an analysis of an individual debt security or issuer and information reasonably sufficient upon which to base an investment decision:

- statistical summaries of multiple companies’ financial data, including listings of current ratings that do not include an analysis of individual companies’ data;
- an analysis prepared for a specific person or a limited group of fewer than 15 persons;
- periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual debt securities in the context of a fund's or account’s past performance or the basis for previously made discretionary investment decisions; or
- internal communications that are not given to current or prospective customers.

The proposed rule change would define the term "debt security" as any "security" as defined in Section 3(a)(10) of the Exchange Act, except for any "equity security" as defined in Section 3(a)(11) of the Exchange Act, any "municipal security" as defined in Section 3(a)(29) of the Exchange Act, any "security-based swap" as defined in Section 3(a)(68) of the Exchange Act, and any "U.S. Treasury Security" as defined in paragraph (p) of FINRA Rule 6710.[25] The proposed definition excludes municipal securities, in part because of FINRA's jurisdictional limitations with respect to such securities. The proposed definition excludes security-based swaps given the nascent and evolving nature of security-based swap regulation.[26] However, FINRA intends to monitor regulatory developments with respect to security-based swaps and may determine to later include such securities in the definition of debt security.

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25 See proposed FINRA Rule 2242(a)(4).

26 The Commission's rulemaking in the area of security-based swaps, pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), is ongoing. In June 2011, the Commission proposed rules addressing policies and procedures with respect to research and analysis for security-based swaps as part of its proposal governing business conduct standards for security-based swap dealers and major security-based swap participants. See Securities Exchange Act Release No. 64766 (June 29, 2011), 76 FR 42396 (July 18, 2011) (Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants). In June 2012, the Commission staff sought comment on a statement of general policy for the sequencing of compliance dates for rules applicable to security-based swaps. See Securities Exchange Act Release No. 67177 (June 11, 2012), 77 FR 35625 (June 14, 2012) (Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act). In May 2013, the Commission re-opened comment on the statement of general policy and on the outstanding rulemaking releases. The comment period was reopened until July 22, 2013. See Securities Exchange Act Release No. 69491 (May 1, 2013), 78 FR 30800 (May 23, 2013) (Reopening of Comment Periods for Certain Proposed Rulemaking Releases and Policy Statements Applicable to Security-Based Swaps).

The proposed rule change would define the term "debt trader" 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.[27]

The proposed rule change would provide that the term "independent third-party debt research report" means a third-party debt research report, in respect of which the person producing the report: (1) has no affiliation or business or contractual relationship with the distributing member or that member's affiliates that is reasonably likely to inform the content of its research reports; and (2) makes content determinations without any input from the distributing member or that member's affiliates.[28]

The proposed rule change would define the term "investment banking department" as any department or division, whether or not identified as such, that performs any investment banking service on behalf of a member.[29] The term "investment banking services" would include, without limitation, acting as an underwriter, participating in a selling group in an offering for the issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital or equity lines of credit or serving as placement agent for the issuer or otherwise acting in furtherance of a private offering of the issuer.[30]

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27 See proposed FINRA Rule 2242(a)(5).

28 See proposed FINRA Rule 2242(a)(6).

29 See proposed FINRA Rule 2242(a)(8).

30 See proposed FINRA Rule 2242(a)(9). The current definition in NASD Rule 2711 includes, without limitation, many common types of investment banking services. The proposed rule change and the equity research filing propose to add the language "or otherwise acting in furtherance of" either a public or private

The proposed rule change would define the term "member of a debt research analyst's household" as any individual whose principal residence is the same as the debt research analyst's principal residence.[31] This term would not include an unrelated person who shares the same residence as a debt research analyst, provided that the debt research analyst and unrelated person are financially independent of one another.

The proposed rule change would define "public appearance" as any participation in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons or before one or more representatives of the media, a radio, television or print media interview, or the writing of a print media article, in which a debt research analyst makes a recommendation or offers an opinion concerning a debt security or an issuer of a debt security.[32] This term shall not include a password protected webcast, conference call or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current debt research report or other documentation that contains the required applicable disclosures, and that the debt research analyst appearing at the event corrects and updates during the event any disclosures in the debt research report that are inaccurate, misleading or no longer applicable.

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offering to further emphasize that the term "investment banking services" is meant to be construed broadly.

31 See proposed FINRA Rule 2242(a)(10).

32 See proposed FINRA Rule 2242(a)(11).

Under the proposed rule change the term "qualified institutional buyer" has the same meaning as under Rule 144A of the Securities Act.[33]

The proposed rule change would define "research department" as any department or division, whether or not identified as such, that is principally responsible for preparing the substance of a debt research report on behalf of a member.[34] The proposed rule change would define the term "subject company" as the company whose debt securities are the subject of a debt research report or a public appearance.[35] Finally, the proposed rule change would define the term "third-party debt research report" as a debt research report that is produced by a person or entity other than the member.[36]

Identifying and Managing Conflicts of Interest

Similar to the proposed equity research rules, the proposed rule change contains an overarching provision that would require members to establish, maintain and enforce written 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 persons outside of the research department, including investment banking, sales and trading and principal trading personnel, subject companies and customers.[37] The proposed rule change then sets forth minimum requirements for those

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33 See proposed FINRA Rule 2242(a)(12).

34 See proposed FINRA Rule 2242(a)(14).

35 See proposed FINRA Rule 2242(a)(15).

36 See proposed FINRA Rule 2242(a)(16).

37 See proposed FINRA Rule 2242(b)(1).

written policies and procedures. These provisions set out the fundamental obligation for a member to establish and maintain a system to identify and mitigate conflicts to foster integrity and fairness in its debt research products and services. The provisions are also intended to require firms to be more proactive in identifying and managing conflicts as new research products, affiliations and distribution methods emerge. This approach allows for some flexibility to manage identified conflicts, with some specified prohibitions and restrictions where disclosure does not adequately mitigate them. Most of the minimum requirements have been experience tested and found effective in the equity research rules.

In general, the proposed rule change adopts, with slight modifications, the structural safeguards that the Joint Report found effective to promote analyst independence and objective research in the equity research rules, but in the form of mandated policies and procedures with some baseline proscriptions.[38] FINRA believes this approach will impose less cost than a pure prescriptive approach by requiring members to adopt a compliance system that aligns with their particular structure, business model and philosophy. FINRA notes that the approach is consistent with FINRA's

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[38] Among the structural safeguards, FINRA believes separation between investment banking and debt research, and between sales and trading and principal trading and debt research, is of particular importance. As such, while the proposed rule change does not mandate physical separation between the debt research department and the investment banking, sales and trading and principal trading departments (or other person who might seek to influence research analysts), FINRA would expect such physical separation except in extraordinary circumstances where the costs are unreasonable due to a firm's size and resource limitations. In those instances, a firm must implement written policies and procedures, including information barriers, to effectively achieve and monitor separation between debt research and investment banking, sales and trading and principal trading personnel.

general supervision rule, which similarly provides firms flexibility to establish and maintain supervisory programs best suited to their business models, reasonably designed to achieve compliance with applicable federal securities law and regulations and FINRA rules.[39] The proposed rule change introduces a distinction between sales and trading personnel—institutional sales representatives and sales traders—and persons engaged in principal trading activities, where the conflicts addressed by the proposal are of most concern.

Specifically, members must implement written policies and procedures reasonably designed to promote objective and reliable debt research that reflects the truly held opinions of debt research analysts and to prevent the use of debt research reports or debt research analysts to manipulate or condition the market or favor the interests of the firm or current or prospective customers or class of customers.[40] Such policies and procedures must, at a minimum, address the following.

Prepublication Review

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39 See NASD Rule 3010, recently adopted with changes as a consolidated FINRA rule by Securities Exchange Act Release No. 71179 (December 23, 2013), 78 FR 79542 (December 30, 2013) (Order Approving File No. SR-FINRA-2013-025). The consolidated rule becomes effective December 1, 2014. FINRA notes that the policies and procedures approach is consistent with the effective practices highlighted by FINRA in its Report on Conflicts of Interest, among them that firms should implement a robust conflicts management framework that includes structures, processes and policies to identify and manage conflicts of interest. See Report on Conflicts of Interest, FINRA (October 2013) at 5, available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf. The proposed changes also help to harmonize with approaches in international jurisdictions, such as the rules of the Financial Conduct Authority in the United Kingdom. See COBS 12.2.5 R, The Financial Conduct Authority Handbook, available at http://fshandbook.info/FS/html/handbook/COBS/12/2.

40 See proposed FINRA Rule 2242(b)(2).

The required policies and procedures must, at a minimum, be reasonably designed to prohibit prepublication review, clearance or approval of debt research by persons involved in investment banking, sales and trading or principal trading, and either restrict or prohibit such review, clearance and approval by other non-research personnel other than legal and compliance.[41] The policies and procedures also must prohibit prepublication review of a debt research report by a subject company, other than for verification of facts.[42] Similar provisions in the equity rules have proven effective to ensure independence of the research department, and FINRA believes that the objectivity of debt research could be compromised to the extent conflicted persons, e.g., those involved in investment banking and trading activities, have an opportunity to review and comment on the content of a debt research report. The proposed rule change would allow limited review by the subject company because it is sometimes in a unique position to verify facts; otherwise, FINRA believes research analysts should confirm that purported facts are based on other reliable information. The proposed rule change allows sections of a draft debt research report to be provided to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or to the subject company for factual review, so long as: (a) the sections of the draft debt research report submitted do

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41 See proposed FINRA Rule 2242(b)(2)(A) and (B). Thus, a firm must specify in its policies and procedures the circumstances, if any, where prepublication review would be permitted as necessary and appropriate pursuant to proposed FINRA Rule 2242(b)(2)(B); for example, where non-research personnel are best situated to verify select facts or where administrative personnel review for formatting. FINRA notes that members still would be subject to the overarching requirement to have policies and procedures reasonably designed to effectively manage conflicts of interest between research analysts and those outside of the research department. See also proposed FINRA Rule 2242.05 (Submission of Sections of a Draft Research Report for Factual Review).

42 See proposed FINRA Rule 2242(b)(2)(N).

not contain the research summary, recommendation or rating; (b) a complete draft of the debt research report is provided to legal or compliance personnel before sections of the report are submitted to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company; and (c) if, after submitting sections of the draft debt research report to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company, the research department intends to change the proposed rating or recommendation, it must first provide written justification to, and receive written authorization from, legal or compliance personnel for the change. The member must retain copies of any draft and the final version of such debt research report for three years after publication.[43]

Coverage Decisions

With respect to coverage decisions, a member's written policies and procedures must restrict or limit input by investment banking, sales and trading and principal trading personnel to ensure that research management independently makes all final decisions regarding the research coverage plan.[44] However, as discussed below, the provision does not preclude personnel from these or any other department from conveying customer interests and coverage needs, so long as final decisions regarding the coverage plan are made by research management. FINRA believes this provision strikes an appropriate balance by allowing input of customer interests in determining the allocation of limited research resources to a wide range of debt securities, while preserving the final decisions for research management.

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[43] See proposed FINRA Rule 2242.05 (Submission of Sections of a Draft Research Report for Factual Review).

[44] See proposed FINRA Rule 2242(b)(2)(C).

Solicitation and Marketing of Investment Banking Transactions

A member's written policies and procedures also must, at a minimum, restrict or limit activities by debt research analysts that can reasonably be expected to compromise their objectivity.[45] This includes prohibiting participation in pitches and other solicitations of investment banking services transactions and road shows and other marketing on behalf of issuers related to such transactions. The proposed rule change adopts Supplementary Material that incorporates an existing FINRA interpretation for the equity research rules that prohibits in pitch materials any information about a member's debt research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable debt research coverage.[46] By way of example, the Supplementary Material explains that FINRA would consider the publication in a pitch book or related materials of an analyst's industry ranking to imply the potential outcome of future research because of the manner in which such rankings are compiled. The Supplementary Material further notes that a member would be permitted to include in the pitch materials the fact of coverage and the name of the debt research analyst, since that information alone does not imply favorable coverage. FINRA notes that, consistent with existing guidance on the equity research rules, debt research analysts may listen to or view a live webcast of a transaction-related road show or other widely attended

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[45] See proposed FINRA Rule 2242(b)(2)(L).

[46] See proposed FINRA Rule 2242.01 (Efforts to Solicit Investment Banking Business).

presentation by investment banking to investors or the sales force from a remote location, or another room if they are in the same location.[47]

The proposed rule change also would prohibit investment banking personnel from directing debt research analysts to engage in sales or marketing efforts related to an investment banking services transaction or any communication with a current or prospective customer about an investment banking services transaction.[48] In addition, the proposed rule change adopts Supplementary Material to provide that, consistent with this requirement, no debt research analyst may engage in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction.[49] FINRA believes that the presence of investment bankers or issuer management could compromise a debt research analyst's candor when talking to a current or prospective customer about a deal.

FINRA believes that the role of any research analyst, debt or equity, is to provide unbiased analysis of issuers and their securities for the benefit of investors, not to help win business for their firms or market transactions on behalf of issuers. FINRA believes the prohibitions in these provisions, which have been a cornerstone of the equity research rules, are equally important to mitigate significant conflicts between investment banking and debt research analysts.

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47 See NASD Notice to Members 07-04 (January 2007) and NYSE Information Memo 07-11 (January 2007).

48 See proposed FINRA Rule 2242(b)(2)(M).

49 See proposed FINRA Rule 2242.02(a) (Restrictions on Communications with Customers and Internal Personnel).

Supervision

A member's written policies and procedures must limit the supervision of debt research analysts to persons not engaged in investment banking, sales and trading or principal trading activities.[50] In addition, they further must establish information barriers or other institutional safeguards to ensure that debt research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking services, principal trading or sales and trading activities or others who might be biased in their judgment or supervision.[51]

The requirement for information barriers or other institutional safeguards to insulate research analysts from pressure is taken from Sarbanes-Oxley, which applies only to research reports on equity securities. FINRA believes this provision has equal application to debt research reports and that firms must not allow supervision or influence by anyone in the firm outside of the research department whose interests may be at odds with producing objective research. FINRA believes that independence for debt research analysts requires effective separation from those whose economic interests may be in conflict with the content of debt research. The proposed rule change furthers that separation by prohibiting oversight of debt research analysts by those involved in investment banking or trading activities.

Budget and Compensation

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[50] See proposed FINRA Rule 2242(b)(2)(D). The provision is substantively the same as current NASD Rule 2711(b)(1), a core structural separation requirement in the equity research rules that FINRA believes is essential to safeguarding analyst objectivity.

[51] See proposed FINRA Rule 2242(b)(2)(H).

A member's written policies and procedures also must limit the determination of a firm's debt research department budget to senior management, excluding senior management engaged in investment banking or principal trading activities, and without regard to specific revenues or results derived from investment banking.[52] However, the proposed rule change would expressly permit all persons to provide input to senior management regarding the demand for and quality of debt research, including product trends and customer interests. It further would allow consideration by senior management of a firm's overall revenues and results in determining the debt research budget and allocation of expenses. FINRA believes the budget provisions strike a reasonable balance by prohibiting final budget determinations by those persons most conflicted, but allowing input from all persons and consideration of revenues other than investment banking to best allocate scarce budget resources.

With respect to compensation determinations, a member's written policies and procedures must prohibit compensation based on specific investment banking services or trading transactions or contributions to a firm's investment banking or principal trading activities and prohibit investment banking and principal trading personnel from input into the compensation of debt research analysts.[53] Further, the firm's written policies and procedures must require that the compensation of a debt research analyst who is primarily responsible for the substance of a research report be reviewed and approved at least annually by a committee that reports to a member's board of directors or, if the member

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52 See proposed FINRA Rule 2242(b)(2)(E).

53 See proposed FINRA Rule 2242(b)(2)(D) and (F).

has no board of directors, a senior executive officer of the member.[54] This committee may not have representation from investment banking personnel or persons engaged in principal trading activities and must consider the following factors when reviewing a debt research analyst's compensation, if applicable: the debt research analyst's individual performance, including the analyst's productivity and the quality of the debt research analyst's research; and the overall ratings received from customers and peers (independent of the member's investment banking department and persons engaged in principal trading activities) and other independent ratings services.

Neither investment banking personnel nor persons engaged in principal trading activities may give input with respect to the compensation determination for debt research analysts. However, sales and trading personnel may give input to debt research management as part of the evaluation process in order to convey customer feedback, provided that final compensation determinations are made by research management, subject to review and approval by the compensation committee.[55] The committee, which may not have representation from investment banking or persons engaged in principal trading activities, must document the basis for each debt research analyst's compensation, including any input from sales and trading personnel.

The compensation provisions are similar to those that have proven effective in the equity research rules. However, the separation extends to not only investment banking, but also those engaged in principal trading activities, because such persons have the most pronounced conflict with respect to debt research. FINRA believes that the

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54 See proposed FINRA Rule 2242(b)(2)(G).

55 See proposed FINRA Rule 2242(b)(2)(D) and (G).

compensation determination is a key source of influence on the content of debt research reports and therefore it is important to require both separation from those who might influence research analysts and consideration of the quality of the research produced in making that determination.

Personal Trading Restrictions

Under the proposed rule change, a member's written policies and procedures must restrict or limit trading by a "debt research analyst account" in securities, derivatives and funds whose performance is materially dependent upon the performance of securities covered by the debt research analyst.[56] The procedures must ensure that those accounts, supervisors of debt research analysts and associated persons with the ability to influence the content of debt research reports do not benefit in their trading from knowledge of the content or timing of debt research reports before the intended recipients of such research have had a reasonable opportunity to act on the information in the report.[57] Furthermore, the procedures must generally prohibit a debt research analyst account from purchasing or selling any security or any option or derivative of such security in a manner inconsistent with the debt research analyst's most recently published recommendation, except that they may define circumstances of financial hardship (e.g., unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account) in which the firm will permit trading contrary to that

56 See proposed FINRA Rule 2242(b)(2)(J).

57 See proposed FINRA Rule 2242.07 (Ability to Influence the Content of a Research Report) would provide that for the purposes of the rule, an associated person with the ability to influence the content of a debt research report is an associated person who, in the ordinary course of that person's duties, has the authority to review the debt research report and change that debt research report prior to publication or distribution.

recommendation. In determining whether a particular trade is contrary to an existing recommendation, firms may take into account the context of a given trade, including the extent of coverage of the subject security. While the proposed rule change does not include a recordkeeping requirement, FINRA expects members to evidence compliance with their policies and procedures and retain any related documentation in accordance with FINRA Rule 4511.

The proposed rule change includes Supplementary Material .10, which provides that FINRA would not consider a research analyst account to have traded in a manner inconsistent with a research analyst's recommendation where a member has instituted a policy that prohibits any research analyst from holding securities, or options on or derivatives of such securities, of the companies in the research analyst's coverage universe, provided that the member establishes a reasonable plan to liquidate such holdings consistent with the principles in paragraph (b)(2)(J)(i) and such plan is approved by the member's legal or compliance department.[58] This provision is intended to provide a mechanism by which a firm's analysts can divest their holdings to comply with a more restrictive personal trading policy without violating the trading against recommendation provision in circumstances where an analyst has, for example, a "buy" rating on a subject company or debt security.

FINRA believes these provisions will protect investors by prohibiting research analysts and those with an ability to influence the content of research reports, such as supervisors, from trading ahead of their customers based on knowledge that may move the market once made public. FINRA further believes the provisions, in general, will

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[58] See proposed FINRA Rule 2242.10.

promote objective research by requiring consistency between personal trading by research analysts and recommendations to customers.

Retaliation and Promises of Favorable Research

A member's written policies and procedures must prohibit direct or indirect retaliation or threat of retaliation against debt research analysts by any employee of the firm for publishing research or making a public appearance that may adversely affect the member's current or prospective business interests.[59] FINRA believes it is essential to a research analyst's independence and objectivity that no person employed by the member that is in a position to retaliate or threaten to retaliate should be permitted to do so based on the content of a research report or public appearance. The policies and procedures also must prohibit explicit or implicit promises of favorable debt research, specific research content or a specific rating or recommendation as inducement for the receipt of business or compensation.[60] This provision is also key to preserving the integrity of debt research and the independence of debt research analysts, who otherwise may feel pressure to tailor the content of debt research to the business interests of the firm.

Joint Due Diligence with Investment Banking Personnel

The proposed rule change establishes a proscription with respect to joint due diligence activities – i.e., due diligence by the debt research analyst in the presence of investment banking department personnel – during a specified time period. Specifically,

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59 See proposed FINRA Rule 2242(b)(2)(I). This provision is not intended to limit a member's authority to discipline or terminate a debt research analyst, in accordance with the member's written policies and procedures, for any cause other than writing an adverse, negative, or otherwise unfavorable research report or for making similar comments during a public appearance.

60 See proposed FINRA Rule 2242(b)(2)(K).

the proposed rule change states that FINRA interprets the overarching principle requiring members to, among other things, establish, maintain and enforce written policies and procedures that address the interaction between debt research analysts, banking and subject companies,[61] to prohibit the performance of joint due diligence prior to the selection of underwriters for the investment banking services transaction.[62] FINRA understands that in some instances, due diligence activities take place even before an issuer has awarded the mandate to manage or co-manage an offering. There is heightened risk in those circumstances that investment bankers may pressure analysts to produce favorable research that may bolster the firm's bid to become an underwriter for the offering. Once the mandate has been awarded, FINRA believes joint due diligence may take place in accordance with appropriate written policies and procedures to guard against interactions to further the interests of the investment banking department. At that time, FINRA believes that the efficiencies of joint due diligence outweigh the risk of pressure on debt research analysts by investment banking.

Communications Between Debt Research Analysts and Trading Personnel

The proposed rule change delineates the prohibited and permissible interactions between debt research analysts and sales and trading and principal trading personnel. The proposed rule change would require members to establish, maintain and enforce written policies and procedures reasonably designed to prohibit sales and trading and principal trading personnel from attempting to influence a debt research analyst's opinions or views for the purpose of benefiting the trading position of the firm, a

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61 See proposed FINRA Rule 2242(b)(1)(C).

62 See proposed FINRA Rule 2242.09 (Joint Due Diligence).

customer or a class of customers.[63] It would further prohibit debt research analysts from identifying or recommending specific potential trading transactions to sales and trading or principal trading personnel that are inconsistent with such debt research analyst's currently published debt research reports or from disclosing the timing of, or material investment conclusions in, a pending debt research report.[64] The communications prohibited under the proposed rule change are intended to prevent undue influence on debt research analysts to generate or conform research to a firm's proprietary trading interests or those of particular customers. FINRA believes that these prohibitions are necessary to mitigate a significant conflict between firms and their customers.

However, FINRA understands that certain communications between debt research analysts and trading desk personnel are essential to the discharge of their functions, e.g., debt research analysts need to obtain from trading personnel information relevant to a valuation analysis and trading personnel need to obtain from debt research analysts information regarding the creditworthiness of an issuer. These departments also must communicate regarding coverage decisions, given the large number of debt instruments.

Therefore, the proposed rule change would permit sales and trading and principal trading personnel to communicate customers' interests to a debt research analyst, so long as the debt research analyst does not respond by publishing debt research for the purpose of benefiting the trading position of the firm, a customer or a class of customers.[65] In

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63 See proposed FINRA Rule 2242.03(a)(1) (Information Barriers between Research Analysts and Trading Desk Personnel).

64 See proposed FINRA Rule 2242.03(a)(2) (Information Barriers between Research Analysts and Trading Desk Personnel).

65 See proposed FINRA Rule 2242.03(b)(1) (Information Barriers between Research Analysts and Trading Desk Personnel).

addition, debt research analysts may provide customized analysis, recommendations or trade ideas to sales and trading and principal trading personnel and customers, provided that any such communications are not inconsistent with the analyst's currently published or pending debt research, and that any subsequently published debt research is not for the purpose of benefiting the trading position of the firm, a customer or a class of customers.[66]

The proposed rule change also would permit sales and trading and principal trading personnel to seek the views of debt research analysts regarding the creditworthiness of the issuer of a debt security and other information regarding an issuer of a debt security that is reasonably related to the price or performance of the debt security, so long as, with respect to any covered issuer, such information is consistent with the debt research analyst's published debt research report and consistent in nature with the types of communications that a debt research analyst might have with customers. In determining what is consistent with the debt research analyst's published debt research, a member may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the debt research analyst's published views.[67] Finally, debt research analysts may seek information from sales and trading and principal trading personnel regarding a particular debt instrument, current

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66 See proposed FINRA Rule 2242.03(b)(2) (Information Barriers between Research Analysts and Trading Desk Personnel).

67 See proposed FINRA Rule 2242.03(b)(3) (Information Barriers between Research Analysts and Trading Desk Personnel).

prices, spreads, liquidity and similar market information relevant to the debt research analyst's valuation of a particular debt security.[68]

The proposed rule change clarifies that communications between debt research analysts and sales and trading or principal trading personnel that are not related to sales and trading, principal trading or debt research activities may take place without restriction, unless otherwise prohibited.[69]

Restrictions on Communications with Customers and Internal Sales Personnel

The proposed rule change would apply standards to communications with customers and internal sales personnel. Any written or oral communication by a debt research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.[70]

Consistent with the prohibition on investment banking department personnel directly or indirectly directing a debt research analyst to engage in sales or marketing efforts related to an investment banking services transaction or directing a debt research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction, no debt research analyst may engage in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking

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68 See proposed FINRA Rule 2242.03(b)(4) (Information Barriers between Research Analysts and Trading Desk Personnel).

69 See proposed FINRA Rule 2242.03(c) (Information Barriers between Research Analysts and Trading Desk Personnel).

70 See proposed FINRA Rule 2242.02(b) (Restrictions on Communications with Customers and Internal Personnel).

services transaction. These provisions are intended to allow debt research analysts to educate investors and internal sales personnel about an investment banking transaction in fair and balanced manner, in a setting that promotes candor by the debt research analyst.[71]

Content and Disclosure in Debt Research Reports

The proposed rule change would, in general, adopt the disclosures in the equity research rule for debt research, with modifications to reflect the different characteristics of the debt market. As discussed above, the equity research rules are designed to provide investors with useful information on which to base their investment decisions. FINRA believes retail debt investors would benefit from similar disclosures applied to debt research reports. In addition, FINRA understands from industry participants that members have systems in place to track the disclosures required under the equity research rules that can be leveraged to meet the debt research disclosure requirements in the proposed rule change.

The proposed rule change would require members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in their debt research reports are based on reliable information.[72] FINRA has included this provision because it believes members should have policies and procedures to foster verification of facts and trustworthy research on which investors may rely. In addition, the policies and procedures must be reasonably designed to ensure that any recommendation or rating has a reasonable basis and is accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may

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[71] See proposed FINRA Rule 2242.02(a) (Restrictions on Communications with Customers and Internal Personnel).

[72] See proposed FINRA Rule 2242(c)(1)(A).

impede achievement of the recommendation or rating.[73] While there is no obligation to employ a rating system under the proposed rule, members that choose to employ a rating system must clearly define in each debt research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based. In addition, the definition of each rating must be consistent with its plain meaning.[74]

Consistent with the equity rules, irrespective of the rating system a member employs, a member must disclose, in each debt research report that includes a rating, the percentage of all debt securities rated by the member to which the member would assign a “buy,” “hold” or “sell” rating.[75] In addition, a member must disclose in each debt research report the percentage of subject companies within each of the “buy,” “hold” and “sell” categories for which the member has provided investment banking services within the previous 12 months.[76] All such information must be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the publication date of the debt research report is less than 15 calendar days after the most recent calendar quarter.[77]

If a debt research report contains a rating for a subject company’s debt security and the member has assigned a rating to such debt security for at least one year, the debt research report must show each date on which a member has assigned a rating to the debt

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[73] See proposed FINRA Rule 2242(c)(1)(B).

[74] See proposed FINRA Rule 2242(c)(2).

[75] See proposed FINRA Rule 2242(c)(2)(A).

[76] See proposed FINRA Rule 2242(c)(2)(B).

[77] See proposed FINRA Rule 2242(c)(2)(C).

security and the rating assigned on such date. This information would be required for the period that the member has assigned any rating to the debt security or for a three-year period, whichever is shorter.[78] Unlike the equity research rules, the proposed rule change does not require those ratings to be plotted on a price chart because of limits on price transparency, including daily closing price information, with respect to many debt securities.

The proposed rule change would require[79] a member to disclose in any debt research report at the time of publication or distribution of the report:

- if the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, any option, right, warrant, future, long or short position), and the nature of such interest;
- if the debt research analyst has received compensation based upon (among other factors) the member's investment banking, sales and trading or principal trading revenues;
- if the member or any of its affiliates: managed or co-managed a public offering of securities for the subject company in the past 12 months; received compensation for investment banking services from the subject company in the past 12 months; or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;

78 See proposed FINRA Rule 2242(c)(3).

79 See proposed FINRA Rule 2242(c)(4).

- if, as of the end of the month immediately preceding the date of publication or distribution of a debt research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month), the member or its affiliates have received from the subject company any compensation for products or services other than investment banking services in the previous 12 months;[80]
- if the subject company is, or over the 12-month period preceding the date of publication or distribution of the debt research report has been, a client of the member, and if so, the types of services provided to the issuer. Such services, if applicable, shall be identified as either investment banking services, non-investment banking securities-related services or non-securities services;
- if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report;[81]
- if the debt research analyst received any compensation from the subject company in the previous 12 months; and
- any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason

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80 See also discussion of proposed FINRA Rule 2242.04 (Disclosure of Compensation Received by Affiliates) below.

81 This provision is analogous to the equity research rule requirement to disclose market making activity.

to know at the time of the publication or distribution of a debt research report.[82]

The proposed rule change would incorporate a proposed amendment to the corresponding provision in the equity research rules that expands the existing "catch all" disclosure to require disclosure of material conflicts known not only by the research analyst, but also by any "associated person of the member with the ability to influence the content of a research report." In so doing, the proposed rule change would capture material conflicts of interest that, for example, only a supervisor or the head of research may be aware of. The "reason to know" standard would not impose a duty of inquiry on the debt research analyst or others who can influence the content of a debt research report. Rather, it would cover disclosure of those conflicts that should reasonably be discovered by those persons in the ordinary course of discharging their functions.

The proposed equity research rules include an additional disclosure if the member or its affiliates maintain a significant financial interest in the debt or equity of the subject company, including, at a minimum, if the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. FINRA did not include this provision in the proposed debt research rule because, unlike equity holdings, firms do not typically have systems to track ownership of debt securities. Moreover, the number and complexity of bonds, together with the fact that a firm may be both long and short different bonds of the same issuer, make it difficult to have real-time disclosure of a firm's credit exposure. Therefore, the proposed rule change only requires disclosure of

82 For example, FINRA would consider it to be a material conflict of interest if the debt research analyst or a member of the debt research analyst's household serves as an officer, director or advisory board member of the subject company.

firm ownership of debt securities in research reports or a public appearance to the extent those holdings constitute a material conflict of interest.[83] While the ownership of the equity securities of the subject company of a debt research report can constitute a conflict of interest for the member that publishes or distributes the research report, FINRA does not believe the conflict requires routine disclosure, even above some threshold of ownership. This is because the impact of a debt research report on the market for an equity security is more attenuated than that of an equity research report. In those circumstances where the impact is heightened – e.g., a debt research report asserting that a subject company may not be able to meet its debt service – disclosure could be captured by the material conflict of interest provision.

The proposed rule change adopts from the equity research rules the general exception for disclosure that would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.[84] Similar to the equity research rules, the proposed rule change would require that disclosures be presented on the front page of debt research reports or the front page must refer to the page on which the disclosures are found. Electronic debt research reports, however, may provide a hyperlink directly to the required disclosures. All disclosures and references to disclosures required by the proposed rule must be clear, comprehensive and prominent.[85]

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83 See proposed FINRA Rules 2242(c)(4)(H) and (d)(1)(E).

84 See proposed FINRA Rule 2242(c)(5).

85 See proposed FINRA Rule 2242(c)(6).

Like the equity research rule, the proposed rule change would permit a member that distributes a debt research report covering six or more companies (compendium report) to direct the reader in a clear manner to the applicable disclosures. Electronic compendium reports must include a hyperlink to the required disclosures. Paper-based compendium reports must provide either a toll-free number or a postal address to request the required disclosures and also may include a web address of the member where the disclosures can be found.[86]

Disclosure of Compensation Received by Affiliates

The proposed rule change would provide that a member may satisfy the disclosure requirement with respect to receipt of non-investment banking services compensation by an affiliate by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the affiliate as to whether the affiliate received such compensation.[87] In addition, a member may satisfy the disclosure requirement with respect to the receipt of investment banking compensation from a foreign sovereign by a non-U.S. affiliate of the member by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the non-U.S. affiliate as to whether such non-U.S. affiliate received or expects to receive such compensation from the foreign sovereign. However, a member

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86 See proposed FINRA Rule 2242(c)(7).

87 See proposed FINRA Rule 2242.04 (Disclosure of Compensation Received by Affiliates).

must disclose receipt of compensation by its affiliates from the subject company (including any foreign sovereign) in the past 12 months when the debt research analyst or an associated person with the ability to influence the content of a debt research report has actual knowledge that an affiliate received such compensation during that time period.

Disclosure in Public Appearances

The proposed rule change closely parallels the equity research rules with respect to disclosure in public appearances. Under the proposed rule, a debt research analyst must disclose in public appearances:[88]

- if the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), and the nature of such interest;
- if, to the extent the debt research analyst knows or has reason to know, the member or any affiliate received any compensation from the subject company in the previous 12 months;
- if the debt research analyst received any compensation from the subject company in the previous 12 months;
- if, to the extent the debt research analyst knows or has reason to know, the subject company currently is, or during the 12-month period preceding the date of publication or distribution of the debt research report, was, a client of the member. In such cases, the debt research analyst also must disclose the types of services provided to the subject company, if known by the debt research analyst; or

[88] See proposed FINRA Rule 2242(d)(1).

- any other material conflict of interest of the debt research analyst or member that the debt research analyst knows or has reason to know at the time of the public appearance.

However, a member or debt research analyst will not be required to make any such disclosure to the extent it would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.[89] Unlike in debt research reports, the "catch all" disclosure requirement in public appearances applies only to a conflict of interest of the debt research analyst or member that the analyst knows or has reason to know at the time of the public appearance and does not extend to conflicts that an associated person with the ability to influence the content of a research report or public appearance knows or has reason to know. FINRA understands that supervisors typically do not have the opportunity to review and insist on changes to public appearances, many of which are extemporaneous in nature.

The proposed rule change would require members to maintain records of public appearances by debt research analysts sufficient to demonstrate compliance by those debt research analysts with the applicable disclosure requirements for public appearances. Such records must be maintained for at least three years from the date of the public appearance.[90]

Disclosure Required by Other Provisions

With respect to both research reports and public appearances, the proposed rule change would require that, in addition to the disclosures required under the proposed rule,

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89 See proposed FINRA Rule 2242(d)(2).

90 See proposed FINRA Rule 2242(d)(3).

members and debt research analysts must comply with all applicable disclosure provisions of FINRA Rule 2210 (Communications with the Public) and the federal securities laws.[91]

Distribution of Member Research Reports

The proposed rule change, like the proposed amendments to the equity research rules, codifies an existing interpretation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and provides additional guidance regarding selective – or tiered – dissemination of a firm’s debt research reports. The proposed rule change requires firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that a debt research report is not distributed selectively to internal trading personnel or a particular customer or class of customers in advance of other customers that the member has previously determined are entitled to receive the debt research report.[92] The proposed rule change includes further guidance to explain that firms may provide different debt research products and services to different classes of customers, provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm discloses its research dissemination practices to all customers that receive a research product.[93]

A member, for example, may offer one debt research product for those with a long-term investment horizon (“investor research”) and a different debt research product for those customers with a short-term investment horizon (“trading research”). These

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91 See proposed FINRA Rule 2242(e).

92 See proposed FINRA Rule 2242(f).

93 See proposed FINRA Rule 2242.06 (Distribution of Member Research Products).

products may lead to different recommendations or ratings, provided that each is consistent with the meaning of the member's ratings system for each respective product. However, a member may not differentiate a debt research product based on the timing of receipt of a recommendation, rating or other potentially market moving information, nor may a member label a debt research product with substantially the same content as a different debt research product as a means to allow certain customers to trade in advance of other customers.

In addition, a member that provides different debt research products and services for certain customers must inform its other customers that its alternative debt research products and services may reach different conclusions or recommendations that could impact the price of the debt security.[94] Thus, for example, a member that offers trading research must inform its investment research customers that its trading research product may contain different recommendations or ratings that could result in short-term price movements contrary to the recommendation in its investment research. FINRA understands, however, that customers may actually receive at different times research reports originally made available at the same time because of the mode of delivery elected by the customer eligible to receive such research services (e.g., in paper form versus electronic). However, members may not design or implement a distribution system intended to give a timing advantage to some customers over others. FINRA will

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94 See proposed FINRA Rule 2242.06 (Distribution of Member Research Products). A member that distributes both institutional and retail debt research would be required to inform its retail customers of the existence of the institutional debt research product and, if applicable, that the product may contain different recommendations or ratings than its retail debt research product. This disclosure need not be in each retail debt research report; rather, a member may establish policies and procedures reasonably designed to inform retail investors of the existence and nature of the institutional debt research product.

read with interest comments as to whether a member should be required to disclose to its other customers when an alternative research product or service does, in fact, contain a recommendation contrary to the research product or service that those customers receive.

Distribution of Third-party Debt Research Reports

FINRA 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. Moreover, the proposed rule change would incorporate the current standards for third-party equity research, including the distinction between independent and non-independent third-party research with respect to the review and disclosure requirements. In addition, the proposed rule change adopts an expanded requirement in the proposed equity research rules that requires members to disclose any other material conflict of interest that can reasonably be expected to have influenced the member's choice of a third-party research provider or the subject company of a third-party research report. FINRA believes that it is important that readers be made aware of any conflicts of interest present that may have influenced either the selection or content of third-party research disseminated to investors.

The proposed rule change would prohibit a member from distributing third-party debt research if it knows or has reason to know that such research is not objective or reliable.[95] FINRA believes that, where a member is distributing or "pushing-out" third-party debt research, the member must have written policies and procedures to vet the quality of the research producers. A member would satisfy the standard based on its

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[95] See proposed FINRA Rule 2242(g)(1).

actual knowledge and reasonable diligence; however, there would be no duty of inquiry to definitively establish that the third-party research is, in fact, objective and reliable.

In addition, the proposed rule change would require a member to establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party debt research report it distributes contains no untrue statement of material fact and is otherwise not false or misleading.[96] For the purpose of this requirement, a member's obligation to review a third-party debt research report extends to any untrue statement of material fact or any false or misleading information that should be known from reading the debt research report or is known based on information otherwise possessed by the member.

The proposed rule change would require that a member accompany any third-party debt research report it distributes with, or provide a web address that directs a recipient to, disclosure of any material conflict of interest that can reasonably be expected to have influenced the choice of a third-party debt research report provider or the subject company of a third-party debt research report, including, at a minimum:

- if the member or any of its affiliates managed or co-managed a public offering of securities for the subject company in the past 12 months; received compensation for investment banking services from the subject company in the past 12 months; or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;

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96 See proposed FINRA Rule 2242(g)(2).

- if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report; and
- any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of the publication or distribution of a debt research report.[97]

The proposed rule change would not require members to review a third-party debt research report prior to distribution if such debt research report is an independent third-party debt research report.[98] For the purposes of the disclosure requirements for third-party research reports, a member shall not be considered to have distributed a third-party debt research report where the research is an independent third-party debt research report and made available by a member upon request, through a member-maintained website, or to a customer in connection with a solicited order in which the registered representative has informed the customer, during the solicitation, of the availability of independent debt research on the solicited debt security and the customer requests such independent debt research.[99]

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97 See proposed FINRA Rule 2242(g)(3).

98 See proposed FINRA Rule 2242(g)(4).

99 See proposed FINRA Rule 2242(g)(5).

The proposed rule would require that members ensure that third-party debt research reports are clearly labeled as such and that there is no confusion on the part of the recipient as to the person or entity that prepared the debt research reports.[100]

Obligations of Persons Associated with a Member

The proposed rule change clarifies the obligations of each associated person under those provisions of the proposed rule that require a member to restrict or prohibit certain conduct by establishing, maintaining and enforcing particular policies and procedures. Specifically, the proposed rule change provides that, consistent with FINRA Rule 0140, persons associated with a member must comply with such member's written policies and procedures as established pursuant to the proposed rule. Failure of an associated person to comply with such policies and procedures shall constitute a violation of the proposed rule.[101] In addition, consistent with Rule 0140, the proposed rule states in Supplementary Material .08 that it shall be a rule violation for an associated person to engage in the restricted or prohibited conduct to be addressed through the establishment, maintenance and enforcement of written policies and procedures required by provisions of FINRA Rule 2242, including applicable Supplementary Material, that embed in the policies and procedures specific obligations on individuals. This Supplementary Material reflects FINRA's position that associated persons can be held liable for engaging in conduct that is proscribed by the member under FINRA rules. FINRA is clarifying this point in the Supplementary Material because the proposed rule change would adopt a policies and

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100 See proposed FINRA Rule 2242(g)(6). This requirement codifies guidance in Notice to Members 04-18 (March 2004) related to equity research reports.

101 See proposed FINRA Rule 2242.08 (Obligations of Persons Associated with a Member).

procedures approach to restricted and prohibited conduct with respect to research in place of specific proscriptions in the current equity research rules. Thus, for example, where the proposed rule requires a member to establish policies and procedures to prohibit debt research analyst participation in road shows, associated persons also are directly prohibited from engaging in such conduct, even where a member has failed to establish policies and procedures. FINRA believes that it is incumbent upon each associated person to familiarize themselves with the regulatory requirements applicable to his or her business and should not be able to avoid responsibility where minimum standards of conduct have been established for members.

Exemption for Members with Limited Investment Banking Activity

Similar to the equity research rules, the proposed rule change exempts from certain provisions regarding supervision and compensation of debt research analysts those members that over 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.[102] Specifically, members that meet those thresholds would be exempt from the requirement to establish, maintain and enforce policies and procedures that: prohibit prepublication review of debt research reports by investment banking personnel or other persons not directly responsible for the preparation, content or distribution of debt research reports (but not principal trading or sales and trading personnel, unless the member also qualifies for the limited principal trading activity exemption); restrict or limit investment banking personnel from input into coverage decisions; limit supervision

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102 See proposed FINRA Rule 2242(h).

of debt research analysts to persons not engaged in investment banking; limit determination of the research department budget to senior management, excluding senior management engaged in investment banking activities; require that compensation of a debt research analyst be approved by a compensation committee that may not have representation from investment banking personnel; and establish information barriers to insulate debt research analysts from the review or oversight by persons engaged in investment banking services or other persons who might be biased in their judgment or supervision.[103] However, the proposed rule would require that members with limited investment banking activity establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in investment banking services activities or other persons, including persons engaged in principal trading or principal sales and trading activities, who might be biased in their judgment or supervision.[104] FINRA believes that even where research analysts need not be structurally separated from investment banking or other non-research personnel, they should not be subject to pressures that could compromise their independence and objectivity.

While small investment banks may need those who supervise debt research analysts under such circumstances also to be involved in the determination of those analysts' compensation, the proposal still prohibits these firms from compensating a debt

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[103] See proposed FINRA Rule 2242(b)(2)(A)(i), (b)(2)(B), (b)(2)(C) (with respect to investment banking), (b)(2)(D)(i), (b)(2)(E) (with respect to investment banking), (b)(2)(G) and (b)(2)(H)(i) and (iii).

[104] For the purposes of proposed FINRA Rule 2242(h), the term "investment banking services transactions" includes the underwriting of both corporate debt and equity securities but not municipal securities.

research analyst based upon specific investment banking services transactions or contributions to a member's investment banking services activities. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to all of the requirements of proposed FINRA Rule 2242(b).

FINRA has found the thresholds in the current equity rule to be reasonable and appropriate: they reduce the challenges and costs of compliance for select provisions for those firms whose limited investment banking business significantly reduces the magnitude of conflicts that could impact investors. In addition, in the context of the equity rules, FINRA analyzed data to see if changing the magnitude of either or both thresholds – the number of transactions managed or co-managed or the amount of gross revenues generated from those transactions – yielded a more appropriate universe of exempted firms. FINRA reviewed and analyzed deal data for calendar years 2009 through 2011. FINRA reviewed firms that either managed or co-managed deals and earned underwriting revenues from those transactions during the review period. The analysis found that 155 of 317 such firms – or 49% – 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. For example, increasing both of the thresholds by 33% (to 40 transactions managed or co-managed and $20 million in gross revenues over a three-year period) would result in 18 additional exempted firms. As such, FINRA believes the current exemption produces a reasonable and appropriate universe of exempted firms. Since the exemption in the equity research rules relates to the same investment banking conflicts that debt research analysts face, FINRA believes the exemption, with its current thresholds, is equally reasonable and appropriate for the debt research rules.

Exemption for Limited Principal Trading Activity

FINRA believes it appropriate to provide an exemption from some provisions of the proposed rule that require separation of debt research from sales and trading and principal trading for firms whose limited principal trading operations results in an appreciably increased burden of compliance relative to the expected investor protection benefits. In general, FINRA believes that firms with modest potential principal trading profits pose lower risk of having sales and trading or principal trading personnel pressure debt analysts, provided other safeguards remain in place. The proposed rule change therefore includes an exemption from certain provisions regarding supervision and compensation of debt research analysts for members that engage in limited principal trading activity where: (1) in absolute value on an annual basis, the member's trading gains or losses on principal trades in debt securities are $15 million or less over the previous three years, on average per year; and (2) the member employs fewer than 10 debt traders; provided, however, such members must establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision.[105] Specifically, members that meet those thresholds would be exempt from the requirement to establish, maintain and enforce policies and procedures that: prohibit prepublication review of debt research reports by principal trading or sales and trading personnel or other persons not directly

[105] See proposed FINRA Rule 2242(i).

responsible for the preparation, content or distribution of debt research reports (but not investment banking personnel, unless the firm also qualifies for the limited investment banking activity exemption); restrict or limit principal trading or sales and trading personnel from input into coverage decisions; limit supervision of debt research analysts to persons not engaged in sales and trading or principal trading activities, including input into the compensation of debt research analysts; limit determination of the research department budget to senior management, excluding senior management engaged in principal trading activities; require that compensation of a debt research analyst be approved by a compensation committee that may not have representation from principal trading personnel; and establish information barriers to insulate debt research analysts from the review or oversight by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision.[106]

As with the limited investment banking activity exemption, members still would be required to establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to all of the requirements of proposed FINRA Rule 2242(b).

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106 See proposed FINRA Rule 2242(b)(2)(A)(ii) and (iii), (b)(2)(B), (b)(2)(C) (with respect to sales and trading and principal trading), (b)(2)(D)(ii) and (iii), (b)(2)(E) (with respect to principal trading), (b)(2)(G) and (b)(2)(H)(ii) and (iii).

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. 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 the assessment, FINRA believes 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. FINRA intends to monitor the research produced by firms that avail themselves of the exemption to assess whether the thresholds to qualify for the exemption are appropriate or should be modified.

Exemption for Debt Research Reports Provided to Institutional Investors

FINRA 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. FINRA 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 selectively incorporate research as a data point in their own analytics) and reaching pricing decisions. Moreover, some well-regarded debt research is produced by analysts that are part of the trading desk. The separation required by the Rule would preclude this source of information. Given the debt market and the needs of its participants, the proposed rule change would exempt debt research distributed solely to eligible institutional investors ("institutional debt research") from most of the provisions regarding supervision, coverage determinations, budget and compensation determinations and all of the disclosure requirements applicable to debt research reports distributed to retail investors ("retail debt research").[107] Under the proposed rule change, the term "retail investor" means any person other than an institutional investor.[108]

FINRA believes that institutional investors should opt in to receive institutional debt research and should be able to choose to receive only debt research that is subject to the full protections of the rule. The proposed rule distinguishes between larger and smaller institutions in the manner in which their opt-in decision is obtained. The larger may receive institutional debt research based on negative consent, while the smaller must affirmatively consent in writing to receive that research.

Specifically, the proposed rule would allow firms to distribute institutional debt research by negative consent to a person who meets the definition of a QIB[109] and where, pursuant to FINRA Rule 2111(b): (1) the member or associated person has a reasonable basis to believe that the QIB 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; and (2) the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the member's recommendations pursuant to FINRA Rule 2111 and such affirmation is broad enough to encompass transactions in debt securities. The proposed rule change would require written disclosure to the QIB that the member may provide debt research reports that are intended for institutional investors and are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors. If

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107 See proposed FINRA Rule 2242(j)(1).

108 See proposed FINRA Rule 2242(a)(13).

109 See proposed FINRA Rule 2242(a)(12) under which a QIB has the same meaning as under Rule 144A of the Securities Act.

the QIB does not contact the member and request to receive only retail debt research reports, the member may reasonably conclude that the QIB has consented to receiving institutional debt research reports.[110] FINRA interprets this standard to allow an order placer, e.g., a registered investment adviser, for a QIB that satisfies the FINRA Rule 2111 institutional suitability requirements with respect to debt transactions to agree to receive institutional debt research on behalf of the QIB by negative consent.

Institutional accounts that meet the definition of FINRA Rule 4512(c) but do not satisfy the higher tier requirements described above may still affirmatively elect in writing to receive institutional debt research. Specifically, a person that meets the definition of "institutional account" in FINRA Rule 4512(c) may receive institutional debt research provided that such person, prior to receipt of a debt research report, has affirmatively notified the member in writing that it wishes to receive institutional debt research and forego treatment as a retail investor for the purposes of the proposed rule. Retail investors may not choose to receive institutional debt research.[111]

To avoid a disruption in the receipt of institutional debt research, the proposed rule change would allow firms to send institutional debt research to any FINRA Rule 4512(c) account, except a natural person, without affirmative or negative consent for a period of up to one year after SEC approval while they obtain the necessary consents. Natural persons that qualify as an institutional account under FINRA Rule 4512(c) must

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110 See proposed FINRA Rule 2242(j)(1)(A)(i) and (ii).

111 See proposed FINRA Rule 2242(j)(1)(B).

provide affirmative consent to receive institutional debt research during this transition period and thereafter.[112]

The proposed exemption relieves members that distribute institutional debt research to institutional investors from the requirements to have written policies and procedures for this research with respect to: (1) restricting or prohibiting prepublication review of institutional debt research by principal trading and sales and trading personnel or others outside the research department, other than investment banking personnel; (2) input by investment banking, principal trading and sales and trading into coverage decisions; (3) limiting supervision of debt research analysts to persons not engaged in investment banking, principal trading or sales and trading activities; (4) limiting determination of the debt research department's budget to senior management not engaged in investment banking or principal trading activities and without regard to specific revenues derived from investment banking; (5) determination of debt research analyst compensation; (6) restricting or limiting debt research analyst account trading; and (7) information barriers to ensure debt research analysts are insulated from review or oversight by investment banking, sales and trading or principal trading personnel, among others (but members still must have written policies and procedures to guard again those persons pressuring analysts). The exemption further would apply to all disclosure requirements, including content and disclosure requirements for third-party research.

Notwithstanding the proposed exemption, some provisions of the proposed rule still would apply to institutional debt research, including the prohibition on prepublication review of debt research reports by investment banking personnel and the

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112 See proposed FINRA Rule 2242.11 (Distribution of Institutional Debt Research During Transition Period).

restrictions on such review by subject companies. While prepublication review by principal trading and sales and trading personnel would not be prohibited pursuant to the exemption, other provisions of the rule continue to require management of those conflicts, including the requirement to impose information barriers to insulate debt research analysts from pressure by those persons. Furthermore, the requirements in Supplementary Material .05 related to submission of sections of a draft debt research report for factual review would apply to any permitted prepublication review by persons not directly responsible for the preparation, content or distribution of debt research reports. In addition, members must prohibit debt research analysts from participating in the solicitation of investment banking services transactions, road shows and other marketing on behalf of issuers and further prohibit investment banking personnel from directly or indirectly directing a debt research analyst to engage in sales and marketing efforts related to an investment banking deal or to communicate with a current or prospective customer with respect to such transactions. The provisions regarding retaliation against debt research analysts and promises of favorable debt research also still apply with respect to research distributed to eligible institutional investors.[113] FINRA believes that, notwithstanding the sophistication of its recipients, minimum objectivity standards should apply to institutional debt research and members should not be encouraged to use debt research analysts for the purpose of soliciting and marketing investment banking transactions.

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[113] See proposed FINRA Rule 2242(j)(2). A member must establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest described in paragraphs (b)(2)(A)(i), (b)(2)(H) (with respect to pressuring), (b)(2)(I), (b)(2)(K), (b)(2)(L), (b)(2)(M), (b)(2)(N) and Supplementary Material .02(a).

While the proposed rule change does not require institutional debt research to carry the specific disclosures applicable to retail debt research, it does require that such research carry general disclosures prominently on the first page warning that: (1) the report is intended only for institutional investors and does not carry all of the independence and disclosure standards of retail debt research reports; (2) if applicable, that the views in the report may differ from the views offered in retail debt research reports; and (3) if applicable, that the report may not be independent of the firm's proprietary interests and that the firm trades the securities covered in the report for its own account and on a discretionary basis on behalf of certain customers, and such trading interests may be contrary to the recommendation in the report.[114] Thus, the second and third disclosures described above would be required only if the member produces both retail and institutional debt research reports that sometimes differ in their views or if the member maintains a proprietary trading desk or trades on a discretionary basis on behalf of some customers and those interests sometimes are contrary to recommendations in institutional debt research reports. Although FINRA typically favors specific disclosure e.g., that a view or recommendation does, in fact, differ or is contrary to the member's trading interests – FINRA believes that the cost to track and identify a specific conflict with respect to institutional debt research reports exceeds the value that specific disclosure would provide to sophisticated institutional investors, particularly since those

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[114] See proposed FINRA Rule 2242(j)(3). With respect to the disclosure requirement, if applicable, that the views in the institutional debt research report may differ from views in retail debt research, FINRA notes institutional debt research is not subject to Supplementary Material .06, which otherwise requires a member to inform its customers of the existence of a different research product offered to other customers that may reach different conclusions or recommendations that could impact the price of the debt security.

investors value timely analysis and trade ideas that could be diminished due to the burdens associated with a specific disclosure requirement.

FINRA believes that this approach will maintain the flow of institutional debt research to most institutional investors and allow firms to leverage existing compliance efforts, while ensuring that those investors who receive institutional debt research through negative consent have a high level of experience in evaluating transactions involving debt securities, and that certain protections remain in place to manage potential conflicts of interest. In addition, FINRA believes that this approach appropriately acknowledges the arm's-length nature of transactions between trading desk personnel and institutional buyers. Finally, FINRA notes that no institutional investor will be exposed to this less-protected institutional research without either negative or affirmative consent, as applicable.

The proposed rule change would require members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that institutional debt research is made available only to eligible institutional investors.[115] A member may not rely on the proposed exemption with respect to a debt research report that the member has reason to believe will be redistributed to a retail investor. The proposed rule change also states that the proposed exemption does not relieve a member of its obligations to comply with the antifraud provisions of the federal securities laws and FINRA rules.[116]

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[115] See proposed FINRA Rule 2242(j)(4).

[116] See proposed FINRA Rule 2242(j)(5).

General Exemptive Authority

The proposed rule change would provide FINRA, pursuant to the FINRA Rule 9600 Series, with authority to conditionally or unconditionally grant, in exceptional and unusual circumstances, an exemption from any requirement of the proposed rule for good cause shown, after taking into account all relevant factors and provided that such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.[117] Given the scope of the rule's subject matter and the diversity of firm sizes, structures and research business and distribution models, FINRA believes it would be useful and appropriate to have the ability to provide relief from a particular provision of the proposed rules under specific factual circumstances.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[118] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change would promote increased quality, objectivity and transparency of debt research distributed to investors by requiring firms to

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117 See proposed FINRA Rule 2242(k).

118 15 U.S.C. 78o-3(b)(6).

identify and mitigate conflicts in the preparation and distribution of such research. FINRA further believes the rule will provide investors with more reliable information on which to base investment decisions in debt securities, while maintaining timely flow of information important to institutional market participants and providing those institutional investors with appropriate safeguards.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rule change largely adopts provisions that have proven effective to promote objective and reliable research in the equity research space, as detailed through academic studies and other observations in the Joint Report and the GAO Report.[119] The GAO report, for example, concluded that empirical studies suggest the rules have resulted in increased analyst independence and weakened the influence of conflicts of interest on analyst recommendations.[120]

The proposed rule change would adopt a policies and procedures approach that allows members to implement a compliance system that aligns with their particular structure and business models, without diminishing investor protection. FINRA believes that this proposed approach imposes less cost on members without reducing investor protections than does a purely prescriptive approach or "one size fits all" approach with respect to compliance. In addition, the proposed rule adopts a substantial portion of the equity research rules. FINRA believes that many of the same conflicts of interest are

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119 See Joint Report, supra note 8 at 12-23.

120 See GAO Report, supra note 9 at 11-15.

present in the publication and distribution of equity and debt research and that consistency among the debt and equity research rules will further minimize the burdens to members to comply with the proposed rule change.

As set forth in Item II.C., FINRA elicited comment on proposed debt research rules in two separate Regulatory Notices. In each instance, FINRA carefully considered the commenters' concerns and amended the proposal to address issues with respect to costs and burdens raised by commenters. Even before the two proposals, FINRA issued a concept proposal in Regulatory Notice 11-11 to gather information and identify provisions of the equity research rules that would not be efficient or effective in a debt research proposal. For example, the concept proposal included a parallel provision to the equity rules that would have required a firm to promptly notify its customers if it intends to terminate coverage in a debt security and include with the notice a final research report. If it were impracticable to provide such final report, the concept proposal would have required a firm to disclose to customers its reason for terminating coverage. FINRA recognized that firms may have an extensive coverage universe of debt securities that may only be the subject of episodic research coverage. As such, FINRA determined that the termination of coverage provision in the debt context would be overly burdensome to firms relative to its investor protection value and therefore eliminated the provision from this revised proposal.

In addition, and as detailed below in Item II.C., FINRA considered numerous iterations of an institutional exemption for debt research. Several commenters raised issues regarding an earlier provision that would have required affirmative consent for all institutional investors. In response to comments that the proposal was overly burdensome and may exclude a significant number of institutional investors from receiving the debt research that they receive today, FINRA is now proposing a higher tier of institutional investors that may receive institutional debt research based on negative consent. As set forth in Regulatory Notice 12-42, FINRA also made several other changes and clarifications in response to comments, including to the definition of "debt research report," the standard for disclosure of conflicts and the permissible interactions between debt research analysts and sales and trading personnel.

FINRA also considered an alternative suggested by commenters to exempt all trader commentary from the protections of the proposed rule. FINRA did not adopt this alternative because it would create an avenue through which firms could funnel debt research to retail investors without objectivity and reliability safeguards or disclosure of conflicts. FINRA reviewed examples of trader commentary and believes that many of those communications either do not meet the definition of a research report or are subject to exceptions from that definition. For those that are debt research reports, FINRA believes retail recipients should be entitled to the same protections, irrespective of the author or department of origin. FINRA further understands that most trader commentary is intended for sophisticated institutional investors, and to the extent a firm limits distribution to eligible institutional investors, most of the provisions of the proposed rule change would not apply. Therefore, FINRA believes its institutional exemption approach strikes the appropriate balance between protecting retail investors and maintaining timely information flow to more sophisticated investors.

FINRA also sought comment and engaged in data analysis, as described in Item II.A.1., to fashion exemptions for firms with limited investment banking activity and limited principal trading activity. In combination with the institutional investor exemption, FINRA believes the proposed rule change is narrowly tailored to achieve its regulatory objectives.

Finally, FINRA notes that it solicited comment in Regulatory Notice 12-42 on the economic impact of the proposed rule change, including quantified costs and the anticipated effects on competition, but received little or no feedback.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Earlier iterations of the proposed rule change were published for comment in Regulatory Notice 12-09 ("Regulatory Notice 12-09 Proposal) and Regulatory Notice 12-42 ("Regulatory Notice 12-42 Proposal") (together, the "Notice Proposals"). Copies of the Regulatory Notices are attached as Exhibit 2a. A list of the commenters and copies of the comment letters received in response to the Notice Proposals are attached as Exhibits 2b and 2c, respectively.

The Regulatory Notice 12-09 Proposal sought comment on a proposed rule to govern the preparation and distribution of debt research pursuant to a tiered approach based on whether debt research is distributed to retail or institutional investors. Under the proposal, debt research distributed to retail investors would carry most of the same protections provided to recipients of equity research, while institutional investors could affirmatively opt in to a framework that would exempt such research from many of those provisions. FINRA received seven comments in response to the proposal.[121]

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[121] See Letter from Joseph R.V. Romano, President, Romano Brothers & Co., to Marcia E. Asquith, Corporate Secretary, FINRA, dated March 31, 2012 ("Romano"); letter from Ryan K. Bakhtiari, President, Public Investors Arbitration Bar Association, to Marcia E. Asquith, Corporate Secretary, FINRA,

Commenters suggested significant changes to the proposal, most notably with respect to the definitions of "debt security" and "debt research report," the opt-in requirement for institutional investors, and the restrictions on input into debt research budget and compensation determinations by those involved in principal trading activities.

FINRA addressed several of the commenters' concerns in the Regulatory Notice 12-42 Proposal, which included, among other things, amended exemptions for research distributed to certain institutional investors and for firms with limited principal debt trading activity. The amended exemption for institutional investors added a higher tier of institutional investor that could receive institutional debt research by negative consent. FINRA received five comment letters on the proposal.[122] The comments focused on two primary issues: the higher tier definition of institutional investor and the restrictions on

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dated April 2, 2012 ("PIABA"); letter from Ira D. Hammerman, Senior Managing Director, General Counsel and Secretary, Securities Industry and Financial Markets Association, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 2, 2012 ("SIFMA"); letter from Michael Nicholas, CEO, Bond Dealers of America, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 2, 2012 ("BDA"); letter from Lee A. Pickard and William D. Edick, Pickard and Djinis LLP, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 2, 2012 ("ASIR"); letter from Chris Charles, President, Wulff, Hansen & Co., to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 5, 2012 ("Wulff"); and letter from Amy Natterson Kroll, Bingham McCutchen LLP, to Marcia E. Asquith, Corporate Secretary, FINRA, dated April 10, 2012 ("Morgan Stanley").

122 See Letter from Kurt N. Schacht, Managing Director, and Linda L. Rittenhouse, Director, CFA Institute, to Marcia E. Asquith, Corporate Secretary, FINRA, dated December 7, 2012 ("CFA"); letter from Michael Nicholas, CEO, Bond Dealers of America, to Marcia E. Asquith, Corporate Secretary, FINRA, dated December 20, 2012 ("BDA"); letter from Lee A. Pickard and William D. Edick, Pickard and Djinis LLP, to Marcia E. Asquith, Corporate Secretary, FINRA, dated December 20, 2012 ("ASIR"); letter from Roberts J. Stracks, Counsel, BMO Capital Markets GKST Inc., to Marcia E. Asquith, Corporate Secretary, FINRA, dated December 20, 2012 ("BMO"); and letter from Kevin A. Zambrowicz, Managing Director, Associate General Counsel, Securities Industry and Financial Markets Association, to Marcia E. Asquith, Corporate Secretary, FINRA, dated January 4, 2013 ("SIFMA").

input by principal trading personnel into research budget and evaluation and compensation determinations. Despite specific requests in the Regulatory Notice, FINRA received little or no comment on the economic impact of the proposal or any particular provisions.

A summary of the comments received on the Notice Proposals and FINRA's responses are set forth below.

Definitions

The Regulatory Notice 12-09 Proposal defined "debt security" to mean any "security" as defined in Section 3(a)(10) of the Exchange Act, except for any "equity security," "municipal security" or "security-based swap" as defined in Section 3(a) of the Exchange Act, or any U.S. Treasury Security as defined in FINRA Rule 6710(p). SIFMA and BDA urged FINRA to expand the exceptions to the definition to include U.S. agency securities and investment grade foreign government securities. BDA again urged FINRA to exclude U.S. agency securities in response to the Regulatory Notice 12-42 Proposal. SIFMA further asked FINRA to clarify that "derivatives," as defined in the CFTC conflict rules are excluded from the definition of "debt security" because they are subject to a separate federal regulatory regime. PIABA, on the other hand, thought FINRA should include municipal securities and security-based swaps within the definition.

FINRA did not believe it was appropriate to expand the exceptions to the definition of "debt security" to include agency securities or foreign sovereign debt securities and did not propose these changes to the definition. FINRA has not provided these exclusions in the proposed rule change for a variety of reasons. First, commenters did not provide a rationale to exclude other non-equity securities. Second, treasury securities are excluded because FINRA is reticent to interfere with the markets involving direct obligations of the United States. In contrast, FINRA already has reporting schemes around agency securities and does not think it appropriate to carve out Fannie Mae and Freddie Mac securities, for example. Municipal securities were excluded from the proposal in part due to FINRA's jurisdictional limitations with respect to those securities, so suggestions to exclude other securities as analogous to municipals are misplaced.

FINRA believes an exclusion for foreign sovereign debt of other G-20 countries is too broad, as the conflicts the rules address are similarly present with respect to research on such securities, and therefore retail investors would benefit from the proposal's protections. Alternatively, commenters asked for greater flexibility with respect to disclosure of compensation on foreign sovereign issues, in large part due to tracking difficulties given the many and diverse relationships that firms' affiliates have with governments. In response, FINRA amended the proposal to permit firms, in lieu of disclosing investment banking compensation received by a non-U.S. affiliate from foreign sovereigns, to instead implement information barriers between that affiliate and the debt research department to prevent direct or indirect receipt of such information.[123] However, the proposed rule change would still require disclosure if the debt research analyst has actual knowledge of receipt of investment banking compensation by the non-U.S. affiliate.

As stated in Item II.A. above, the proposed rule excludes security-based swaps from the definition of debt security given the nascent and evolving nature of security-

[123] See proposed FINRA Rule 2242. 04 (Disclosure of Compensation Received by Affiliates).

based swaps regulation. FINRA intends to monitor regulatory developments with respect to security-based swaps and may determine to later include such securities in the definition of debt security.

The Regulatory Notice 12-09 proposal defined "debt research report" as any written (including electronic) communication that includes an analysis of debt securities and that provides information sufficient upon which to base an investment decision. The term excluded the same communications excepted from the definition of "research report" in NASD Rule 2711. Morgan Stanley and SIFMA suggested that the definition should be amended to conform to the definition of "research report" in Regulation AC, which defines "research report" as a "written communication . . . that includes an analysis of a security or issuer . . . ." They further suggested that FINRA should include an exception from the definition of "research report" similar to interpretive guidance found in the Commission's adopting release about the general characteristics of that term as it is used in Regulation AC for "reports commenting on or analyzing particular types of debt securities or characteristics of debt securities" that do not include an analysis of, or recommend or rate individual securities or companies. In response to comments to both of the Notice Proposals, FINRA agreed that the definition of "debt research report" should be consistent with the definition in Regulation AC and therefore amended the proposal to achieve that regulatory harmony, including the exception for reports on classes of debt securities. This amendment is reflected in the proposed rule change.

In response to a suggestion by BDA to the Regulatory Notice 12-09 Proposal, FINRA included the exceptions to the definition of "debt research report" in the rule text rather than by reference to the exceptions in NASD Rule 2711. BDA, BMO, Morgan

Stanley, SIFMA, and Wulff, in response to one or both of the Notice Proposals, suggested that FINRA should exclude from the definition desk communications, including trader commentary, if such communications are sent only to institutional investors. Among other arguments, these commenters asserted that trader commentary is common in the debt markets, that institutions don't rely on it as the sole basis for their investment decisions and that inclusion of trader commentary within the definition of "debt research report" is unduly burdensome and costly and could reduce available market information to investors without "commensurate policy returns." BDA asserted that the proposal would categorically eliminate an entire segment of analysis for retail investors without providing evidence that it is a harmful or abusive practice. In response to Regulatory Notice 12-42, BDA also stated that the definition should exclude offering documents for unregistered transactions and securities and any document prepared by or at the request of the issuer or obligor of a security.

FINRA continues to believe it imprudent to create a broad exception from the definition of "debt research report" based on the author or department of origin. As explained in Regulatory Notice 12-09, such an approach creates a potential loophole through which biased and non-transparent research could be disseminated to investors, including retail investors. FINRA notes that the Sarbanes-Oxley Act declined to adopt such an approach in the equity context. Furthermore, Regulation AC has no such exception, so the regulatory consistency that commenters seek would be undermined. If, as commenters maintain, trader commentary is mostly provided only to institutions, then the institutional research exemption could exclude these communications from most of the provisions of the rule that otherwise apply to retail debt research for institutions that opt in. While FINRA understands that institutions may be more attuned to conflicts, FINRA believes it appropriate that even institutional debt research should retain certain minimum standards of independence and transparency, including restrictions on prepublication review by investment banking and the issuer, prohibitions on promises of favorable research as an inducement for receipt of business or compensation and general disclosure alerting recipients of the lesser standards and potential conflicts of interest attendant to the research report.

FINRA declined BDA's suggestion to exclude from the definition of "debt research report" offering documents for unregistered transactions or any document prepared by or at the request of the issuer or obligor of a security. BDA offered no rationale for the exclusions, which would be inconsistent with Regulation AC. Moreover, FINRA believes an exception for any document requested by an issuer would seriously undermine the regulatory purpose of the proposed rule change because it would allow a broker-dealer to distribute to retail investors a communication that contains all of the elements of a debt research report but none of the protections where the issuer, a conflicted party, requested it be created.

Prepublication Review

The proposed rule change maintains provisions in the Notice Proposals that would prohibit prepublication review, clearance or approval of debt research reports by investment banking, principal trading and sales and trading personnel. In response to the Regulatory Notice 12-09 Proposal, SIFMA contended that the rule should permit investment banking and sales and trading to review debt research reports prior to publication for factual accuracy, subject to appropriate supervision. As an example, SIFMA cited research on new complex structured products, suggesting analysts need to verify with investment banking or sales and trading that the basic facts about the products are correct and to corroborate the accuracy of the analyst's statements regarding trading activity, prevailing market prices or yields. SIFMA also pointed out that current NASD Rule 2711 permits such factual review of research reports by investment banking and other non-research personnel.

First, FINRA notes that it has proposed to eliminate any prepublication review by investment banking or other persons not directly responsible for the preparation, content and distribution of equity research reports, other than legal and compliance personnel. FINRA believes that review of facts in a report by investment banking and other non-research personnel is unnecessary in light of the numerous other sources available to verify factual information, including the subject company. FINRA notes that such review may invite pressure on a research analyst that could be difficult to monitor. FINRA further notes that such factual review is not permitted under the terms of the Global Settlement[124] and that FINRA staff has seen no evidence that the factual accuracy of research produced by Global Settlement firms has suffered. Second, with respect to debt research, the proposal delineates certain permissible communications between debt research analysts and sales and trading and principal trading personnel necessary for each to effectively discharge their responsibilities and facilitate debt market trading. Among the allowable communications, a debt research analyst may seek information from sales and trading and principal trading personnel regarding a "particular bond instrument,

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124 See Letter from James A. Brigagliano, Assistant Director, SEC Division of Trading and Markets, to Dana G. Fleischman, Clearly, Gottlieb, Steen & Hamilton, dated Nov. 2, 2004.

current prices, spreads, liquidity and similar market information relevant to the debt research analyst's valuation of a particular security." In light of these permissible communications, and the other reasons stated above, FINRA sees no compelling reason why a debt research analyst needs further factual review from sales and trading or principal trading personnel by sharing portions of a draft research report. FINRA believes that any incremental improvement in accuracy by permitting factual review by investment banking, principal trading or sales and trading personnel is outweighed by the increased risk of pressure on a research analyst and the prospect that the perceived objectivity of the research may be undermined. Therefore, the proposed rule change does not incorporate the commenter's suggestion.

Research Department Budget

The Regulatory Notice 12-09 Proposal limited determination of the research department budget to senior management, other than persons engaged in investment banking or principal trading activities, and without regard to specific revenues or results derived from those activities. However, the proposal noted that revenues and results of the firm as a whole may be considered in determining the debt research department budget and allocation of research department expenses. Moreover, the proposal permitted all persons within the firm to provide senior management input regarding the demand for and quality of debt research, including product trends and customer interests.

In response to that proposal, SIFMA commented that senior management should be permitted to consider principal trading and other business revenues in making budget decisions, else senior management cannot accurately marry research funding to customer needs. SIFMA further contended that the proposal's other provisions adequately safeguard against inappropriate pressures by investment banking and principal trading with respect to debt research budget determinations. The Regulatory Notice 12-42 Proposal maintained these restrictions on debt research budget input, and in response, SIFMA again asserted that the provision denies research management the ability to assess the value of the permissible input by comparing it to the revenues generated from principal trading activities, thereby resulting in a misallocation of resources. SIFMA contended that the allocation of the research department's resources to a particular asset class "will be and should be influenced by the size and profitability of the respective market."

FINRA appreciates the desire of firms to allocate research costs based on the revenues to which the research department contributes, but also sees a countervailing investor protection interest in firms managing conflicts between their revenue-producing operations and research. FINRA believes that the size and allocation of the research budget should be insulated from pressure by those business segments. In the case of investment banking, FINRA believes the conflict is too pronounced to allow any consideration of investment banking revenues in determining the research department budget. However, given the vast array of debt securities and classes, FINRA believes it appropriate to allow some consideration of revenue streams in allocating research budget resources. Therefore, the proposed rule change would permit consideration of those revenues, provided that: (1) senior management, other than persons engaged in principal trading or investment banking activities, makes the final research department budget determination;[125] and (2) the member establishes information barriers or other

[125] See proposed FINRA Rule 2242(b)(2)(E).

institutional safeguards to ensure that debt research analysts are insulated from the review, pressure or oversight by persons engaged in principal trading activities, among others.[126]

Debt Research Analyst Evaluation and Compensation

With respect to evaluation and compensation of debt research analysts, the proposed rule change maintains a provision in the Notice Proposals that would allow sales and trading personnel, but not persons engaged in principal trading activities, to provide input to research management into the evaluation of a debt research analyst, so long as research management makes final determinations on compensation, subject to review by the compensation committee.

In response to the Regulatory Notice 12-09 Proposal, SIFMA argued that the proposal was too strict in prohibiting the input of principal trading personnel and contributions to principal trading activities in determining debt research analyst compensation. SIFMA asserted that as long as final compensation decisions rest with research management and the compensation committee, FINRA should allow input from principal trading personnel because those individuals regularly interface with customers and therefore are a necessary resource for customer feedback on the quality and productivity of debt research analysts. SIFMA also noted that the provision would preclude input from persons who wear multiple hats and engage in both sales and principal trading activities. Finally, SIFMA contended that compensation prohibitions fail to acknowledge the important role that debt research analysts play in assisting market making and customer facilitation desks.

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126 See proposed FINRA Rule 2242(b)(2)(H).

In response to Regulatory Notice 12-42, SIFMA reiterated that the provision will deprive research management of important client feedback to evaluate debt research analysts' performance because principal traders are the primary conduit for such information. According to SIFMA, there are limited means to obtain direct customer feedback on the quality of research, and reliance on the sales force to provide customer feedback is inadequate because debt traders can have as much or more interaction with clients. In addition, SIFMA noted that the CFTC business conduct rules permit employees of the business trading unit or clearing unit of a swap dealer or major swap participant to communicate customer feedback, ratings and other indicators of research analyst performance to research department management.[127]

While FINRA recognizes that there is some value in input from those engaged in principal trading activities, FINRA believes such input is outweighed by conflicts that could provide incentive for principal trading personnel to reward or punish a debt research analyst with selected feedback based on whether his or her research or trading ideas benefitted the firm's trading activities. Conversely, debt research analysts may feel compelled to produce research and trade ideas to benefit firm or particular customer positions if their compensation is tied to contributions to principal trading activities. Moreover, FINRA believes, in part based on discussions with research management personnel, that input from sales and trading personnel provides an effective proxy for customer feedback, to the extent such feedback cannot be obtained directly from

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127 The CFTC rules apply to research on derivatives, which is predominantly an institutional business. As noted below, the proposed rule change exempts from the compensation prohibitions institutional debt research. By comparison, SIFMA asked to allow principal traders to relay customer feedback in connection with retail debt research.

customers. Furthermore, FINRA believes that research management should be in a position to assess the quality of the research it oversees. Finally, to the extent firms qualify for the limited principal trading exemption in the proposed rule change, dual-hatted persons engaged in both research and principal trading activities would be able to provide feedback to research department management.

Given the importance of principal trading operations to the revenues of many firms, FINRA believes there is increased risk that principal traders could improperly pressure or influence debt research if they have input into analyst compensation or can solicit, relay or characterize customer feedback on retail debt research. FINRA believes this risk, which if manifested could directly impact retail investors, outweighs the benefit of an additional data point for research management to evaluate the quality of research produced by analysts they oversee.

BDA stated that FINRA should amend the proposal to clarify that debt research analyst compensation may be based on the revenues and results of the firm as a whole. FINRA agrees that a member may consider the overall success of the firm when determining a debt analyst’s compensation, provided the member complies with the compensation review and approval requirements. FINRA notes that the proposed rule change specifies that the revenues and results of the firm as a whole may be considered in determining the research department budget, including expenses. Since debt analyst compensation is a research department expense, FINRA does not believe it necessary to further amend the compensation provisions.

Prohibitions on Interactions with Investment Banking Personnel

The proposed rule change would require members to have written policies and procedures to prohibit participation in pitches and other solicitations of investment banking services transactions and participation in road shows and other marketing on behalf of an issuer related to investment banking services transactions.

The Regulatory Notice 12-09 Proposal had a similar provision, but did not limit the marketing prohibition to investment banking services transactions. SIFMA asked whether the proposed requirement with respect to road shows was intended to operate identically with NASD Rule 2711. SIFMA also asked FINRA to clarify that, consistent with NASD Rule 2711, the prohibition on road shows is only intended to cover road shows and other marketing related to an investment banking transaction and not non-deal road shows. FINRA is primarily concerned with marketing by research analysts in connection with an investment banking services transaction, and therefore FINRA has added that limitation to the provision in proposed rule change. FINRA notes, however, that the overarching requirement to have written policies and procedures to manage conflicts related to the interaction between debt research analysts and, among others, subject companies would apply to other marketing activity on behalf of an issuer. FINRA does not believe that merely facilitating a meeting between issuer management and investors, absent other facts, would constitute marketing on behalf of the issuer.

In response to the Regulatory Notice 12-09 Proposal, SIFMA contended that the prohibition on joint due diligence conducted with the subject company in the presence of investment banking personnel was overly restrictive. FINRA has clarified in the proposed rule change that the prohibition on joint due diligence applies only during the period prior to the selection by the issuer of the underwriters for the investment banking services transaction.[128] In response to the Regulatory Notice 12-42 Proposal, SIFMA commented that debt research analysts should be able to passively attend road show presentations because, unlike equity analysts that frequently have access to issuer management, the road show is often the only opportunity for a debt research analyst to view an issuer's management presentation and evaluate the credibility of management's business plan and outlook. SIFMA contended that it is impractical for issuers to meet separately with debt research analysts and challenging for analysts to call in and listen to an issuer presentation. SIFMA also noted that the concern is more pronounced in certain sectors of the debt markets, such as high-yield and emerging markets.

FINRA does not believe that the prohibition with respect to road show participation should differ between the debt and equity research rules, since the conflicts are the same. FINRA believes the ability to listen remotely to a road show presentation provides debt research analysts a reasonable means to hear the issuer management's story, while not appearing to be part of the deal team to prospective customers attending the presentation in person. Therefore, FINRA did not amend this provision of the proposal.

Prohibitions on Interactions with Sales and Trading

The proposed rule change maintains a provision in the Notice Proposals that would require members to have written policies and procedures to prohibit certain interactions between debt research and sales and trading and principal trading personnel. The proposed rule change also delineates prohibited and permissible communications between those persons. In response to the Regulatory Notice 12-09 Proposal, SIFMA

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[128] See proposed FINRA Rule 2242.09 (Joint Due Diligence).

asked FINRA to clarify that the prohibition on attempting to influence analysts for the purpose of benefiting the firm, a customer or class of customers would not capture ordinary-course communications and is meant to prohibit non-research direction over the decision to publish a report and non-research direction over the views and opinions expressed in debt reports. The proposed rule provides that communications between debt research analysts and trading desk personnel that are not related to sales and trading, principal trading or debt research activities may take place without restriction, unless otherwise prohibited.[129]

SIFMA also recommended that FINRA include in the proposed rule text the language provided in Regulatory Notice 12-09 that, in assessing whether a debt research analyst's permissible communications are "inconsistent" with the 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. FINRA incorporated the suggested language into proposed FINRA Rule 2242.[130]

ASIR noted that the Regulatory Notice 12-09 Proposal goes beyond NASD Rule 2711 by restricting not only communications between analysts and investment banking, but also between debt research analysts and sales and trading personnel. ASIR asserted that the debt research proposal should only restrict communications between research and investment banking personnel, so as to harmonize with the equity rules.

The proposed rule change specifically addresses communications between debt research and sales and trading and principal trading personnel because the interests of the

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129 See proposed FINRA Rule 2242.03(c).

130 See proposed FINRA Rule 2242.03(b)(3).

trading department create a particularly pronounced conflict with respect to debt research. This is because, under current market conditions, principal trading is far more prevalent in the debt markets than in the equity markets. However, FINRA continues to monitor the relationship between equity research and sales and trading and principal trading personnel to assess whether similar specific restrictions should be applied in the equity research context. FINRA notes that the current and proposed equity research rules do require firms to manage conflicts between equity research and other non-research personnel, including those engaged in sales and trading and principal trading activities.

Conflicts Disclosure

With respect to the Regulatory Notice 12-09 Proposal, SIFMA and BDA found overly broad the provision that requires disclosure of "all conflicts that reasonably could be expected to influence the objectivity of the research report and that are known or should have been known by the member or debt research analyst on the date of publication or distribution of the report." SIFMA contended that the language would require firms to identify "all possible conflicts (material or immaterial)" and encouraged FINRA to either specify the conflicts it intends to capture or rely on the standard in NASD Rule 2711 requiring disclosure of "actual, material" conflicts. SIMFA further questioned whether conflicts could ever be expected to influence the objectivity of research reports and suggested that existing FINRA research rules and Regulation AC assume the contrary.

In response to SIFMA's doubt that conflicts could ever be expected to influence the objectivity of research reports, FINRA notes that its research rules are premised on the belief that conflicts can be disinfected – and possibly discouraged – by disclosure and will give investors the material information needed to assess the objectivity of a research report. In addition, the rules prohibit certain conduct where the conflicts are too pronounced to be cured by disclosure. Yet the rules do not – and cannot – identify every such conflict. Thus, at a minimum, FINRA's proposal would require firms to identify and disclose them.

In general, FINRA believes that an immaterial conflict could not reasonably be expected to influence the objectivity of a research report, and therefore a materiality standard is essentially congruent with the proposed standard. FINRA agrees that the "catch-all" disclosure provision captures such material conflicts that the research analyst and persons with the ability to influence the content of a research report know or have reason to know. Therefore, FINRA has amended the proposal to delete as superfluous the overarching obligation to disclose "all conflicts that reasonably could be expected to influence the objectivity of the research report and that are known or should have been known by the member or research analyst on the date of publication or distribution of the report."

SIFMA also contended that the requirement in proposed FINRA Rule 2242(c)(5) to disclose information on the date of publication or distribution is broader than current NASD Rule 2711, which only applies at the time of publication, and problematic logistically because the broader standard is not reflective of the conflicts that apply at the time the debt research analyst writes the research report. In addition, SIFMA argues that it is unclear how members could control and prevent the distribution of reports that have already been published in order to determine if additional disclosures are required. FINRA notes that the term "distribution" is drawn from the provisions of the Sarbanes-

Oxley Law that apply to equity research reports and is intended to capture research that may only be distributed electronically as opposed to published in hard copy. FINRA has included the same "publication or distribution" language in the proposed changes to the equity research rules. However, FINRA interprets this language to require the disclosures to be current only as of the date of first publication or distribution, provided that the research report is prominently dated, and the disclosures are not known to be misleading.

The proposed rule text in the Regulatory Notice 12-09 Proposal required firms to ensure any recommendation or rating has a reasonable basis in fact and is accompanied by a clear explanation of the valuation method utilized and a fair presentation of the risks that may impede achievement of the recommendation or rating. SIFMA requested clarification that the requirement with respect to valuation method should apply only if the analyst used a "formal" valuation method. FINRA is not clear what constitutes a "formal" valuation method, but made a clarification in the proposed rule change to provide that any recommendation or rating must be accompanied by a clear explanation of "any" (as opposed to "the") valuation method used.

SIFMA also sought several other clarifications on the proposal. First, it asked FINRA to clarify that the requirement to include in research reports that contain a rating a distribution of "all securities rated by the member to which the member would assign a 'buy,' 'hold,' or 'sell' rating" is limited to debt securities. FINRA agrees that the proposed provision is limited to debt securities and has changed the text accordingly. Second, SIFMA sought flexibility to make a good faith determination as to which securities constitute a debt security that must be accompanied by a "ratings table," given that bonds of the same issuer may have different ratings. FINRA agrees that any ratings table should reflect ratings of distinct securities rather than issuers. Finally, SIFMA requested guidance to distinguish between a “recommendation” and a “rating” for the purposes of disclosure under the revised proposal. In particular, SIFMA suggested that a recommendation of a relative value or paired trade idea should constitute a recommendation but not a rating. While any determination will be fact specific, FINRA believes in general that a recommendation is a suggestion to make a particular investment while a rating is a label or conclusion attached to a research report.

SIFMA asked that FINRA allow firms to modify the required “health warning” disclosure for institutional debt research to refer to “this document” rather than “this research report” when the material is not prepared by research department personnel. While FINRA would permit firms to use the word “document” rather than “research report,” such labeling must be used consistently and would have no bearing on whether the communication constitutes a “research report” for purposes of the proposed rule.

Third-Party Research Reports

With respect to distribution of third-party debt research reports, SIMFA objected to requirements in the Notice Proposals that do not currently apply to equity research under NASD Rule 2711. In particular, SIFMA cited the requirement to establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party debt research report it distributes is “reliable and objective.” SIFMA stated that it is unclear what FINRA means by “objective.” With respect to the requirement to disclose “any material conflict of interest that can reasonably expected to have influenced the choice of a third-party debt research provider or the subject company of a third-party debt research report," SIFMA stated that it is "not clear what types of conflicts this provision is intended to capture."

FINRA notes that its equity research proposal contains identical requirements with respect to the selection and distribution of third-party research. FINRA believes it reasonable to require firms to conduct upfront due diligence on the quality of its third-party research providers, particularly given the lesser review obligations imposed prior to distribution. FINRA notes that Global Settlement firms had to have such procedures to select their independent research providers,[131] and FINRA does not believe it unreasonable to have some type of screening procedures to ensure, for example that the third-party provider is not being paid by the issuer or that the research has some kind of track record or good reputation. In fact, in a 2006 comment letter, SIFMA stated that firms should "demand high standards" from providers of third-party research.[132] FINRA further believes it appropriate for firms to disclose to investors any relationship, e.g., an affiliate relationship, or other circumstances that rise to a material conflict of interest that could reasonably be seen as having influenced the choice of third-party research provider. FINRA believes this disclosure is consistent with the requirement to disclosure material conflicts of interest with respect to a firm's own research, and therefore will similarly promote objectivity and transparency of information provided to investors that may influence their investment decisions. FINRA notes that a firm may avoid the requirement

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131 See Letter from James A. Brigagliano, Assistant Director, SEC Division of Trading and Markets, to Dana G. Fleischman, Clearly, Gottlieb, Steen & Hamilton, dated Nov. 2, 2004.

132 See Letter from Michael D. Udoff, SIFMA, to Nancy M. Morris, Secretary, SEC, dated Nov. 14, 2006.

to review third-party research for false or misleading statements if it chooses to distribute only independent third-party research.[133]

In response to the Notice Proposals, ASIR commented that the proposal could be read to impose obligations on members who make available third-party research pursuant to Section 28(e) of the Exchange Act to have procedures to ensure that such research is reliable and objective and labeled in a certain manner. FINRA is not proposing to make any changes based on this comment. However, research made available pursuant to Section 28(e) is not "distributed" and therefore the proposed requirements would not apply.

Institutional Investor Definition

The Regulatory Notice 12-09 proposal would have exempted from many of the rule's provisions debt research reports disseminated only to "institutional investors," provided that those institutional investors had, prior to receipt of a debt research report, affirmatively notified the member in writing that they wished to forego treatment as a retail investor for the purposes of the rule. ASIR, BDA and SIFMA found this provision unnecessarily burdensome and difficult to implement and track. The commenters noted that they already expend resources to document similar consents under FINRA's suitability rule and that the nature of research distribution makes it more challenging than the suitability rule to track and process all eligible institutional investors that have consented to receive institutional debt research. Commenters instead advocated an approach whereby persons or entities that otherwise meet the definition of "institutional investor" – as defined in FINRA Rule 4512(c) – are presumed to have consented to the

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133 See proposed FINRA Rules 2242(g)(2) and (g)(4).

institutional debt research regime unless they affirmatively choose to receive the protections afforded recipients of retail debt research. Among other things, these commenters asserted that this alternative approach would be less costly and burdensome to administer and that the remaining protections afforded institutional debt research under the proposal, together with the content standards applicable to institutional communications pursuant to FINRA's Communications with the Public rules,[134] provide less sophisticated institutional investors adequate protections should they not to choose be treated as retail investors for the purposes of debt research.

After considering these comments and discussing the issue further with industry members, FINRA proposed a revised institutional investor exemption in the Regulatory Notice 12-42 Proposal. Under the revised proposal, institutional investors that meet the definition of QIB and satisfy the FINRA Rule 2111 institutional suitability standards with respect to debt trading and strategies would be eligible to receive institutional debt research by way of negative consent. Other institutional investors that meet the definition in FINRA Rule 4512(c) but do not satisfy the higher tier requirements could still affirmatively elect in writing to receive institutional debt research. The revised proposal asked whether alternative standards for the higher tier would be more appropriate, including one that combines the FINRA Rule 4512(c) definition and the institutional suitability requirements.

CFA Institute supported the revised higher tier of QIB plus suitability standard in Regulatory Notice 12-42. SIFMA, BDA and BMO opposed it. BDA asserted that all

[134] At the time of the comment letters, those content standards were found in NASD IM-2110-1. Since that time, the Commission has approved a consolidated FINRA communications with the public rule, and those standards are now found in FINRA Rule 2210(d).

QIBs should be able to receive research on debt securities without consent since they are in the business of investing and that an institutional suitability standard should be imposed to determine whether other institutional accounts may receive institutional debt research. BMO expressed concern that the proposal to require affirmative consent is cumbersome and burdensome and would deprive some smaller and mid-size institutional investors of research they receive today, in part because experience has shown that some institutional clients cannot or will not provide the affirmation required in FINRA Rule 2111.

SIFMA contended that the proposal had both practical and logical flaws. SIFMA maintained that the QIB component would introduce a problematic new standard that would require complex and costly systems to track QIB certifications and link them to FINRA Rule 2111 certifications and research distribution lists. SIFMA stated that one firm estimated a cost of $5 million to develop such a system. SIFMA further noted that suitability certifications are tracked at the order placer level, whereas QIBs are tracked for particular transactions. SIFMA also asserted that the proposal would lead to anomalous results, such as the circumstance where a dual registered investment adviser has multiple institutional accounts, only some of which have QIB certificates. SIFMA asked how the registered investment adviser could meet its duty to all of its clients but only utilize the institutional debt research for the QIBs. SIFMA further questioned the logic of a proposal that would allow institutional investors to transact in restricted securities but not receive research on those securities without taking additional steps.

SIFMA offered two alternatives for the higher tier: (1) Non-natural persons that satisfy institutional suitability requirements with respect to debt trading and strategies; or

(2) certain order placing institutions: QIBs; registered broker-dealers, banks, savings and loans, insurance companies, registered investment companies; registered investment advisers; institutions with $50-$100 million in assets and represented by an independent investment adviser; and universities, regulatory and government entities that use research for academic purposes.

FINRA does not believe that retail investors or less sophisticated institutional investors should be required to take any additional steps to receive the full protections of the proposed rule. FINRA believes that some QIBs may lack expertise and experience in debt market analysis and trading, including some employee benefit plans, trust funds with participants of employee benefit plans and charitable organizations. For the same reasons, FINRA believes SIFMA’s first alternative is too broad in that it would require less sophisticated institutional customers to affirmatively opt-in to the full protections of the rule. Therefore, the proposed rule change would adopt a standard under which firms may use negative consent only for the higher standard QIBs that also satisfy the institutional suitability requirements under FINRA Rule 2111 with respect to debt transactions, and affirmative consent from any institutional account as defined in FINRA Rule 4512(c). To avoid a disruption in the receipt of institutional debt research, the proposed rule change would allow firms to send institutional debt research to any FINRA Rule 4512(c) account, except a natural person, without affirmative or negative consent for a period of up to one year after SEC approval while they obtain the necessary consents. Natural persons that qualify as an institutional account under Rule 4512(c) must provide affirmative consent to receive institutional debt research during this transition period and thereafter.

FINRA believes that the proposed institutional investor definition strikes an appropriate balance between protecting less sophisticated institutional investors and maintaining the flow of research – and minimizing the burdens and costs of distributing debt research – to knowledgeable institutional investors. The exemption provides additional protections beyond the FINRA Rule 4512(c) standard for firms to receive institutional debt research by negative consent by ensuring that those institutions satisfy the higher QIB standard and are both capable of evaluating investment risks with respect to debt trading and strategies and have affirmatively indicated that they are exercising independent judgment in evaluating recommendations for such transactions. FINRA believes an affirmative consent requirement is appropriate for FINRA Rule 4512(c) accounts, which are more likely to include investors lacking experience in debt market analysis and trading. To the extent a FINRA Rule 4512(c) institutional investor values institutional debt research, FINRA believes the proposed rule change imposes a one-time small burden on such investors to provide written consent. Some firms indicated to FINRA that the consent could be obtained at the time of other required written authorizations. FINRA believes the one-year grace period will ease the transition to the new rules without disrupting the current flow of debt research to institutional clients.

As to SIFMA's second alternative above, FINRA believes it would only exacerbate SIFMA's stated concerns about introducing a new standard, as the suggested standard has no precedent and is even more complex and presumably difficult to track than the QIB plus suitability standard FINRA proposes to adopt to receive institutional debt research by negative consent.

SIFMA also commented that even if FINRA adopted its preferred institutional suitability standard for the higher tier, many firms may not avail themselves of the exemption because of cost, logistics and obligations to provide their research to retail customers. Thus, SIFMA asked to narrow the scope of restricted persons by adopting the following definition of "principal trading" to mean:

> Engaging in proprietary trading activities for the trading book of a member but does not include transactions undertaken as part of underwriting related, market making related, or hedging activities, or otherwise on behalf of clients.

FINRA declined to adopt the suggested definition. FINRA believes the definition is overly broad and ambiguous and could encourage traders to pressure debt research analysts to support firm inventory positions. For example, the proposed definition would seem to permit traders of auction rate securities to participate in the determination of compensation for debt research analysts, thereby sanctioning the type of concerning conduct that served as a catalyst for rulemaking in this area. For the same reason, FINRA declines a request by BMO for FINRA to clarify that persons who position debt inventory to sell on a principal basis to customers but not for a firm's proprietary trading account would not be deemed to be engaged in principal trading activities.

SIFMA indicated to FINRA in discussions subsequent to their comment letter that firms with large institutional client bases were divided on whether the QIB-based negative consent standard or the FINRA Rule 4512(c) affirmative consent standard would be preferable from a cost efficiency perspective. The proposed rule change provides both options, which FINRA believes will help reduce the costs to satisfy the exemption requirements. The proposed rule change further reduces the costs of compliance by interpreting the QIB-based alternative to capture both QIBs and any order placer (e.g. registered investment adviser) that has at least one QIB sub-account. FINRA believes this interpretation addresses SIFMA's concern that suitability certifications are tracked at the order placer level, while QIBs are tracked for particular transactions, as well as concerns as to how the requirement would apply to a registered investment adviser with both QIB and non-QIB accounts. FINRA understands that the single $5 million estimate referenced by SIFMA in its letter was based in large part on the cost of developing a system that could directly link institutional suitability certifications to QIB sub-accounts and that the interpretation would appreciably reduce the burden.

Limited Investment Banking or Principal Trading Activities Exemptions

The proposed rule change includes an exemption for firms with limited investment banking activity, which is defined as managing or co-managing 10 or fewer investment banking services transactions on average per year over the previous three years and generating $5 million or less in gross investment banking revenues from those transactions. The proposed rule change also includes an exemption for firms that engage in limited principal trading activity where, in absolute value on an annual basis, the member's trading gains or losses on principal trades in debt securities are $15 million or less over the previous three years, on average per year, and the member employs fewer than 10 debt traders.

In response to Regulatory Notice 12-42, CFA opposed both the proposed exemption for firms with limited investment banking and the proposed exemption for firms with limited principal debt trading activities because they would allow influences that could compromise the independence and accuracy of debt research distributed to retail investors. FINRA did not propose any changes based on CFA's comments. With respect to the limited investment banking exemption, FINRA notes that this provision parallels an exemption in the equity research rules and FINRA has not found any evidence of abuse by firms subject to the exemption. With respect to the exemption for limited principal trading activity, FINRA notes that it would be limited to those firms whose limited trading activity makes the conflicts less pronounced and where it would be a significant marginal cost to add a trader dedicated to producing research.

In response to Regulatory Notice 12-09, Wulff and Romano expressed concerns regarding the exemption for firms that engage in limited investment banking activity, arguing that it did not go far enough to curtail the burden of the proposed rule on small firms, many of which have associated persons that engage in both producing debt research and principal trading activities, and that the thresholds were not appropriate for a proposal regarding debt research conflicts of interest. FINRA subsequently amended the proposal to add a more targeted exemption for firms with limited principal trading activity. The exemption, discussed in detail in Item II.A.1., addresses the concerns of small firms with dual-hatted persons by exempting those firms that engage in modest principal trading activity from the restrictions on supervision and compensation determination of debt research analysts by those engaged in sales and trading and principal trading activities. As noted above, FINRA determined the thresholds for the exemption based on data analysis and a survey of firms that engage in principal trading activity.

In addition, FINRA maintained the exemption for firms with limited investment banking activity, exempting eligible firms from similar supervision and compensation determination restrictions with respect to investment banking personnel. FINRA also engaged in data analysis, discussed in Item II.A.1., to confirm the appropriateness of the proposed thresholds for that exemption.

Effective Date

In response to both Regulatory Notices, SIFMA requested that FINRA establish an effective date that will provide adequate time for implementation of the proposed rule change, e.g., 12 to 18 months after SEC approval. FINRA notes that it will provide sufficient time for implementation taking into account any required systems changes.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2014-048 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Brent J Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2014-048. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2014-048 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[135]

Brent J Fields

Secretary

[135] 17 CFR 200.30-3(a)(12).

Exhibit 2a

Regulatory Notice 12-09

Debt Research Reports

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

Comment Period Expires: April 2, 2012

Executive Summary

FINRA seeks comment on a revised debt research conflicts of interest proposal that reflects changes based on comments to a concept proposal discussed in *Regulatory Notice 11-11*. The revised proposal maintains a tiered approach based on whether debt research is distributed to retail or institutional investors. Debt research distributed to retail investors would carry most of the same protections provided to recipients of equity research, while institutional investors could opt in to a framework that exempts such research from many of those provisions.

The text of the proposed rule can be found at *www.finra.org/notice/12-09*.

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.

February 2012

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

- FINRA Rule 2111
- NASD Rule 2711

Financial Industry Regulatory Authority

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 2, 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

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

FINRA sought comment in *Regulatory Notice 11-11* on a concept proposal to require firms to identify and manage conflicts of interest related to the preparation and distribution of debt research reports. The concept proposal adopted a tiered approach that generally would provide retail debt research recipients with the same extensive protections provided to recipients of equity research (with certain modifications to reflect the unique nature and trading of debt securities), while exempting debt research provided solely to institutional investors from many of those provisions, including nearly all disclosure requirements. The concept proposal further provided that institutional investors could opt in to the more protective regime afforded debt research distributed to retail investors. Additionally, the concept proposal set forth unique guidelines for communications between debt research analysts and sales and trading personnel that acknowledged (1) the need to ration a debt analyst's resources among the multitude of debt securities; (2) the limitations on price discovery in the debt markets; and (3) the need for trading personnel to perform credit risk analyses with respect to current and prospective inventory.

FINRA received six comment letters in response to the concept proposal. Based in part on those comments and further discussions with the industry, FINRA now seeks comment on a revised debt research proposal. The key provisions of the revised proposal are set out below; however, interested parties should carefully read the attached rule text for a complete and detailed understanding of the proposal.

Definitions

The concept proposal defined "debt security" 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" closely followed the current definition of equity research report—*i.e.*, a communication that includes an analysis of a debt security and provides information reasonably sufficient upon which to base an investment decision—and contained the same exceptions currently in place for equity (*e.g.*, discussions of broad-based indices and commentaries on economic, political or market conditions).

The revised proposal generally maintains those definitions, but further excludes security-based swaps from the definition of debt security, given the nascent and evolving nature of security-based swap regulation. However, FINRA intends to monitor regulatory developments with respect to security-based swaps and may determine to later include such securities in the definition of debt security.

In addition to requesting a carve-out for security-based swaps, commenters also asked FINRA to narrow the definition of debt security to exclude other non-equity securities not traditionally considered debt securities, as well as agency securities and foreign sovereign debt of G-20 countries, which commenters likened to treasury and municipal securities. FINRA has not provided these exclusions in the revised proposal for a variety of reasons. First, commenters did not provide a rationale to exclude other non-equity securities. Second, treasury securities are excluded because FINRA is reticent to interfere with the markets involving direct obligations of the United States. In contrast, FINRA already has reporting schemes around agency securities and does not think it appropriate to carve out Fannie Mae and Freddie Mac securities, for example. Municipal securities were excluded from the proposal in light of FINRA's jurisdictional limitations with respect to those securities, so suggestions to exclude other securities as analogous to municipals are misplaced. FINRA believes an exclusion for foreign sovereign debt of other G-20 countries is far too broad and that investors would benefit from the proposal's protections with respect to research on such securities.

FINRA also has declined a commenter's suggestion to exclude "trader commentary" and other analytical communications prepared by non-research personnel. FINRA believes it is more appropriate to tier the rule based on the sophistication of the recipient rather than the department of origin of the communication. The Sarbanes-Oxley Act prohibits the latter approach in the equity context, and FINRA believes the reasoning applies equally with respect to debt research: to exempt all research that emanates outside of the research department would create a large loophole through which biased and non-transparent research could be disseminated to retail investors.

The definition of "institutional investor" in the concept proposal was the same as "institutional account" in FINRA's suitability rule.[3] Thus, the proposed definition generally covered:

- a bank, savings and loan association, insurance company or registered investment company;
- 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
- any other entity (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.

The revised proposal maintains the same core institutional investor definition. FINRA does not think it appropriate to expand the definition, as one commenter suggested, to include persons that meet the monetary thresholds of an "accredited investor" under Rule 501 of SEC Regulation D. FINRA believes the monetary thresholds under the "accredited investor" standard—among others, various entities with total assets in excess of just $5 million and individuals with income in excess of $200,000 for the past two years—are far too low as a proxy for sophistication with respect to debt trading.

Notably, the concept proposal contemplated that persons scoped within the definition of institutional investor could elect to be treated as a retail investor for the purposes of these rules. Upon careful consideration, FINRA is now proposing that eligible institutional investors must consent to receiving institutional debt research that is not subject to all of the rule's protections. Thus, the revised proposal requires an otherwise eligible institutional investor to affirmatively notify the member firm in writing that it wishes to forego treatment as a retail investor and receive the more limited protections afforded to debt research distributed only to such institutional customers. FINRA recognizes that not all institutional investors have equal sophistication or prefer to forego the retail protections. Accordingly, FINRA believes it most appropriate in this context that investors who want the full protections of the rules should not be required to take additional steps to receive those protections.

Identifying and Managing Conflicts of Interest

The revised proposal incorporates most of the structural safeguards contemplated by the concept proposal. In that regard, the revised proposal requires firms to establish, maintain and enforce policies and procedures reasonably designed to identify and manage conflicts of interest related to (1) the preparation, content and distribution of debt research reports; (2) public appearances by debt research analysts; and (3) the interaction between debt research analysts and those outside the research department, including investment banking, sales and trading and principal trading personnel,[4] subject companies and investors.

Prepublication Review

Those aforementioned policies and procedures must, at a minimum, prohibit pre-publication review, clearance or approval of debt research by persons involved in investment banking, sales and trading or principal trading, and either restrict or prohibit such review and approval by other non-research personnel other than legal and compliance. They also must prohibit prepublication review of a debt research report by a subject company, other than for verification of facts.

Coverage

With respect to coverage decisions, the policies and procedures must restrict or limit input by investment banking, sales and trading and principal trading personnel to ensure that final determinations are made independently by research management. However, as discussed below, the provision does not preclude personnel from these or any other department from conveying customer interests and coverage needs, so long as final decisions regarding the coverage plan are made by research management.

Solicitation and Marketing of Investment Banking Transactions

The revised proposal further requires firms to restrict or limit activities by debt research analysts that can reasonably be expected to compromise their objectivity, including prohibiting participation in solicitations of investment banking business and road shows and other marketing on behalf of issuers. Moreover, investment banking personnel may not direct debt research analysts to engage in prohibited marketing efforts or any communication with a current or prospective customer about an investment banking services transaction.

Supervision

The revised proposal also requires firms to implement policies and procedures reasonably designed to promote objective and reliable research that reflects the truly held opinions of debt research analysts and prevent the use of debt research reports or debt analysts to manipulate or condition the market in favor of the interests of the firm or current or prospective customers or class of customers.

Those policies and procedures must limit the supervision of debt research analysts to persons not engaged in investment banking, sales and trading or principal trading activities. They further require information barriers or other institutional safeguards to ensure debt analysts are insulated from the review, oversight or pressure from persons engaged in investment banking or principal trading activities or others who might be biased in their judgment or supervision.

Budget and Compensation

In addition, the revised proposal limits determination of a firm's debt research department budget to senior management, other than persons engaged in investment banking or principal trading activities, and without consideration of specific revenues or results derived from such activities. However, the revised proposal expressly permits all persons to provide input to senior management regarding the demand for and quality of debt research, including product trends and customer interests. It further allows consideration by senior management of a firm's overall revenues and results in determining the debt research budget and allocation of expenses.

With respect to compensation determinations, the revised proposal requires policies and procedures to prohibit compensation based on specific investment banking or trading transactions or contributions to a firm's investment banking or principal trading activities. Further, a committee must annually review and approve a debt analyst's compensation, taking into consideration productivity and quality of research and the ratings received from customers and peers independent of the firm's investment banking department or persons involved in principal trading activities. Sales and trading personnel, but not persons engaged in principal trading activities, may give input to research management as part of the evaluation process, provided that final compensation determinations are made by research management, subject to review and approval by the compensation committee. The committee, which may not have representation from investment banking or persons engaged in principal trading activities, must document the basis for each debt analyst's compensation, including any input from sales and trading personnel.

Personal Trading

The revised proposal also requires firms to restrict or limit trading by a "debt research analyst account" in securities, derivatives and funds whose performance is materially dependent upon the performance of securities covered by the debt analyst. Firm procedures must ensure that those accounts, supervisors of debt research analysts and associated persons with the ability to influence the content of debt research reports do not benefit in their trading from the knowledge of the content or timing of debt research reports before the intended recipients of such research have a reasonable opportunity to act on the information in the report. Furthermore, the procedures must generally prohibit a research analyst account from trading in a manner inconsistent with a debt research analyst's most recently published recommendation, except that they may define circumstances of financial hardship (*e.g.*, unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account) in which the firm will permit trading contrary to that recommendation. In determining whether a particular trade is contrary to an existing recommendation, firms may take into account the context of a given trade, including the frequency of coverage of the subject security.

Retaliation and Promises of Favorable Research

The revised proposal requires firms to prevent direct or indirect retaliation or threat of retaliation against debt research analysts by any employee of the firm for publishing research or making a public appearance that may negatively impact a current or prospective business interest.

It also prohibits explicit or implicit promises of favorable debt research, specific research content or a specific rating or recommendation as inducement for the receipt of business compensation.

Content and Disclosure in Debt Research Reports

With respect to debt research distributed to retail investors, the revised proposal imposes most of the same disclosure requirements that apply in the equity research context, with a few modifications (discussed below) to reflect certain differences between the debt and equity markets.

Recommendations and Ratings

As a predicate matter, the revised proposal requires a firm to ensure that any purported facts in a debt research report have a reasonable basis. A firm similarly must ensure that any recommendation or rating has a reasonable basis in fact and is accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation or rating. While there is no obligation to employ a rating system, the revised proposal requires firms that choose to do so to clearly define in each debt research report the meaning of each of its ratings, including the time horizon or any benchmark on which the rating is based. Moreover, the definition of ratings must be consistent with their plain meanings; *e.g.*, "hold" cannot mean "sell."

As with the equity research rules, irrespective of the rating system employed, a firm must include in each debt research report that includes a rating, the percentage of all securities rated by the firm that the firm would assign a "buy," "hold" or "sell" rating, and further indicate the percentage of subject companies in each of those categories for which the firm has provided investment banking services within the previous 12 months. That information must be current as of the end of the most recent calendar quarter, unless the publication date of the research is less than 15 days after the most recent quarter, in which case the information must be current as of the second most recent quarter.

Where a firm has rated a debt security for at least one year, the firm also must include in each debt research report all previously assigned ratings to that security and the corresponding dates. Unlike the equity research rules, the revised proposal does not require those ratings to be plotted on a price chart because of limits on price transparency, including daily closing price information, with respect to many debt securities.

Conflicts Disclosure

The revised proposal includes an overarching provision to require firms to disclose in debt research reports all conflicts that reasonably could be expected to influence the objectivity of the debt research report and that are known or should have been known by the firm or the debt research analyst on the date of publication or distribution of the report, including:

- if the debt research analyst or a member of his or her household has a financial interest in the debt or equity securities of the subject company and the nature of such financial interest;
- if the debt research analyst has received compensation based upon (among other factors) the firm's investment banking or sales and trading revenues; and
- if the firm managed or co-managed a public offering of securities for the subject company in the past 12 months, received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.

The revised proposal also requires disclosure if, as of the end of the month immediately preceding publication or distribution of a debt research report, the firm or its affiliates has received non-investment banking compensation from the subject company in the previous 12 months. Similar to the equity research rules, the revised proposal contains supplementary material that allows firms to satisfy this disclosure requirement with respect to affiliate receipt of non-investment banking compensation with policies and procedures reasonably designed to prevent debt research analysts and persons with the ability to influence the content of debt research reports from receiving information about receipt of such compensation, unless the debt research analyst has actual knowledge of an affiliate receiving subject company compensation during the applicable time period. The revised proposal also requires disclosure if, over the 12-month period preceding publication or distribution of a debt research report, the subject company has been a client of the firm and the types of services provided to the subject company.

The revised proposal further requires disclosure if the firm trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report. This provision is analogous to the equity rule requirement to disclose market making activity. Additionally, the proposal mandates disclosure if the debt research analyst received any compensation from the subject company in the previous 12 months. Finally, there is an omnibus provision requiring disclosure of "any other material conflict of interest of the debt research analyst or firm that the debt research analyst or an associated person of the firm with the ability to influence the content of a debt research report knows or has reason to know" at the time of the publication or distribution of a debt research report. This "reason to know" standard does not impose a duty of inquiry on the debt analyst or others who can influence the content of a debt research report. Instead, as with the equity research rules, it covers disclosure of those conflicts that should reasonably be discovered in the ordinary course of business.

The concept proposal would have required firms to disclose if the firm or its affiliates "maintain a significant financial interest in the debt or equity of the subject company," including, at a minimum, if the firm or its affiliates beneficially own 1 percent or more of any class of common equity securities of the subject company. Commenters expressed concern that firms do not have systems to track such ownership and that the number and complexity of bonds, together with the fact that a firm may be both long and short bonds of the same issuer, make it difficult to have real-time disclosure of a firm's credit exposure.

In response to these comments, the revised proposal has deleted that specific disclosure provision; rather, it requires disclosure in a debt research report of a firm's or its affiliate's debt or equity positions in the subject company only where the positions amount to a material conflict of interest that the debt research analyst or a person with ability to influence the content of a research report knows or has reason to know at the time of publication or distribution of the debt research report. A similar standard would also apply to disclosure in public appearances. This modification recognizes the difficulty in establishing a standard for materiality of debt holdings given the fungibility of issuer bond offerings and the possibility that a firm may have offsetting short positions. It further reflects that a significant equity position (1 percent) in the subject company of a debt research report may not be material depending on the type of debt security that is the subject of the report. Accordingly, the proposal sharpens the focus of disclosure of equity and debt holdings to those facts and circumstances where such holdings may reasonably be expected to influence the objectivity of the debt research report. FINRA notes that because disclosure would be limited to instances when the debt research analyst or a person with the ability to influence the content of a debt research report knows or has reason to know of such material conflict of interest, a firm could choose to wall off those persons as an alternative to tracking and disclosing such interests.

The revised proposal also provides that disclosures need not be made if they would reveal material non-public information regarding specific potential investment banking transactions of the subject company.

Termination of Coverage

The concept proposal included a parallel provision to the equity rules that would have required a firm to promptly notify its customers if it intends to terminate coverage in a debt security and include with the notice a final research report. If it were impracticable to provide such final report, the concept proposal would have required a firm to disclose to customers its reason for terminating coverage. FINRA recognizes that firms may have an extensive coverage universe of debt securities that may only be the subject of episodic research coverage. As such, FINRA believes the termination of coverage provision in the debt context would be overly burdensome to firms relative to its investor protection value and therefore has eliminated the provision from this revised proposal.

Public Appearances

The revised proposal closely parallels the equity research rules with respect to disclosure in public appearances, with the exception referenced above regarding disclosure of firm holdings of the equity of the subject company. Thus, the revised proposal requires disclosure by debt research analysts in public appearances:

- of the analyst and his or her household member's financial interest in the subject company;
- if the analyst knows or has reason to know that the firm or any affiliate received compensation from the subject company in the previous 12 months;
- if the debt analyst received compensation from the subject company in the previous 12 months;
- if the analyst knows or has reason to know that the subject company has been a client in the previous 12 months and the nature of services provided; and
- of any other material conflict of interest of the debt research analyst or firm that the analyst knows or has reason to know at the time of the public appearance.

There is no disclosure obligation where doing so would reveal material non-public information regarding specific potential future investment banking transactions. Firms must maintain records of public appearances sufficient to demonstrate compliance with the disclosure requirements.

Standards Applicable to Research Distributed to Institutional Investors

The revised proposal generally maintains the construct of the concept proposal, effectively allowing institutional investors to be treated as counterparties in many regards. As such, the revised proposal exempts research distributed solely to eligible institutional investors (institutional debt research) from most of the provisions regarding supervision, coverage determination, budget and compensation determination and all of the disclosure requirements applicable to debt research reports distributed to retail investors (retail debt research).

Despite expressly inviting comment on the topic in the concept proposal, FINRA staff received no comments on the relative merits of an opt-in versus an opt-out approach to the institutional framework. Some commenters, however, asserted that institutions should have no option to be treated as retail investors, while other commenters argued against any tiered treatment of research distributed to institutions. FINRA continues to believe a narrowly tailored exemption for institutional debt research is appropriate. However, FINRA again invites comment on whether this aspect of the revised proposal strikes the appropriate balance between investor protection and the needs of market participants. FINRA notes that no firm would be obligated to create or maintain a retail debt research product—a firm may choose to offer debt research only to those eligible persons that opt in to the institutional framework.

Certain provisions still will apply to debt research distributed to eligible institutional investors, including the prohibition on prepublication review of debt research reports by investment banking personnel and the restrictions on such review by subject companies. In addition, firms still must prohibit debt research analysts from participating in the solicitation of investment banking services transactions, road shows and other marketing on behalf of issuers and further prohibit investment banking personnel from directly or indirectly directing a debt research analyst to engage in sales and marketing efforts related to an investment banking deal or communicate with a current or prospective customer with respect to such transactions. The provisions regarding retaliation against debt research analysts and promises of favorable debt research also still apply with respect to research distributed to eligible institutional investors.

While the revised proposal does not require institutional debt research to carry the specific disclosures applicable to retail debt research, it does require that such research carry general disclosures prominently on the first page warning that (1) the report is intended only for institutional investors and does not carry all of the independence and disclosure standards of retail debt research reports; (2) if applicable, that the views in the report may differ from the views offered in retail debt research reports; and (3) if applicable, that the report may not be independent of the firm's propriety interests and that the firm trades for its own account and for certain customers, and such trading interests may be contrary to any recommendation in the report.

Additionally, the revised proposal requires firms to implement policies and procedures reasonably designed to ensure that institutional debt research is made available only to eligible institutional investors. A firm may not rely on the exemptions for institutional debt research if it has reason to believe the research will be redistributed to a retail investor. Thus, if despite having in place reasonably designed policies and procedures, a firm learns that institutional debt research has routinely been redistributed to retail investors, the firm must discontinue distribution of institutional only debt research to that party until it reasonably concludes that measures have been taken to prevent future redistribution.

Communications Between Debt Research Analysts and Trading Desk Personnel

The concept proposal delineated certain permissible and prohibited communications between debt research and sales and trading personnel. The former were intended to allow those communications essential to the discharge of the primary functions of debt analysts and sales and trading personnel; more specifically, the need for debt analysts to obtain from trading personnel information relevant to a valuation analysis and for trading personnel to obtain from debt analysts information regarding the creditworthiness of an issuer. In addition, the concept proposal recognized the need to communicate regarding coverage decisions, given the vast universe of debt instruments. The prohibited communications, on the other hand, were intended to prevent undue influence on debt analysts to generate or conform research to a firm's proprietary trading interests or those of particular customers.

Many commenters suggested the prohibitions were too restrictive. In particular, commenters suggested that sales and trading personnel should be able to communicate customer interests to debt research analysts and that debt research analysts should not be precluded from generating trade ideas and strategies that were not contained in currently published research.

In response, the revised proposal clarifies in supplementary material the permissible interactions between debt research and sales and trading and principal trading personnel, specifically that (1) sales and trading and principal trading personnel may communicate customers' interests to research personnel, so long as debt research analysts do not respond by publishing research that is intended to benefit any trading position of the firm, a customer or a class of customers; and (2) debt research analysts may provide customized analysis and recommendations or trade ideas to sales and trading and principal trading personnel and customers, provided that any such communications are not inconsistent with the analyst's currently published or pending research and that any subsequent research is not for the purpose of benefiting any firm or customer positions.[5]

The revised proposal maintains the general prohibition against sales and trading and principal trading personnel attempting to influence a debt research analyst's opinions or views for the purpose of benefiting the trading position of the firm, a customer or a class of customers. It further prohibits debt research analysts from identifying or recommending specific potential trading transactions to sales and trading or principal trading personnel that are inconsistent with such debt research analyst's currently published debt research reports and from disclosing the timing of, or material investment conclusions in, a pending debt research report.

Distribution of Member and Third-Party Research Reports

The revised proposal requires firms to establish, maintain and enforce policies and procedures reasonably designed to ensure that a firm does not selectively distribute a debt research report to trading personnel or a particular customer or class of customers in advance of other customers that are entitled to receive the debt research report. The revised proposal includes supplementary material explaining that this provision does not preclude offering different research products to different customers, as long as the product is not differentiated only by the timing of receipt of recommendations, ratings or other potential market-moving information.

The revised proposal also sets out the requirements for the review and distribution of third-party research. It generally incorporates the current standards for third-party equity research, including the distinction between independent and non-independent third-party research with respect to the review and disclosure requirements. In short, a firm need not review independent third-party debt research prior to distribution and may not have to include certain otherwise applicable disclosures depending on whether the research is "distributed" or "made available." Firms must have procedures to ensure that non-independent third-party debt research, including affiliate research, contains no untrue statement of material fact and is not otherwise false or misleading. Such review extends to false or misleading information that should be known from a reading of the report or is actually known based on other information the firm possesses. Prior approval is not required; the review procedures can be risk-based.

The revised proposal further requires that firms ensure that third-party research is clearly labeled as such, is reliable and objective and discloses any material conflict of interest that can reasonably be expected to have influenced the choice of third-party research provider or the subject company of a third-party debt research report.

Exemption for Members With Limited Investment Banking Activity

The revised proposal exempts from certain provisions regarding supervision and compensation of debt research analysts those firms that over 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. This is the same metric used for an exemption from certain provisions of the equity research rules. However, FINRA specifically requests comment on whether there is a more appropriate metric for an exemption in the debt research context, one that focuses not necessarily on the size of firms, but on the circumstances where the conflicts related to debt research are less pronounced. For example, such an exemption could be based on limited principal trading activity or revenues generated from debt trading. FINRA encourages commenters to include specific metrics for any proposed exemption.

Supplementary Material

The revised proposal contains supplementary material to provide guidance on various provisions. In addition to the communications between research and trading and the disclosure of non-investment banking services compensation discussed above, the supplementary material addresses:

- prohibitions on information in pitch materials;
- prohibitions on joint due diligence conducted with an issuer in the presence of investment banking personnel;
- restrictions on communications with customers and internal personnel;
- submission of sections of a draft debt research report for factual review;
- persons with the ability to influence the content of a research report; and
- obligations of persons associated with a member firm with respect to provisions that require the firm to have policies and procedures restricting or prohibiting certain conduct.

Request for Comment

FINRA welcomes all comments on the revised proposal. The comment period expires on April 2, 2012.

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. *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).

4. FINRA notes that the revised proposal introduces a distinction between sales and trading personnel—institutional sales representatives and sales traders—and persons engaged in principal trading activities, where the conflicts addressed by the proposal are most concerning.

5. In assessing whether a debt research analyst's permissible communications with sales and trading and principal trading personnel and customers are "inconsistent" with the analyst's published research, a firm may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the analyst's published views.

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.

Exhibit 2b

Alphabetical List of Written Comments
Regulatory Notice 12-09

1. Ryan K. Bakhtiari, Public Investors Arbitration Bar Association (April 12, 2012)

2. Chris Charles, Wulff, Hansen & Co. (April 5, 2012)

3. Ira D. Hammerman, SIFMA (April 2, 2012)

4. Amy Natterson Kroll, Bingham McCutchen LLP (April 10, 2012)

5. Michael Nicholas, Bond Dealers of America (April 2, 2012)

6. Lee A. Pickard and William D. Edick, Pickard and Djinis LLP (April 2, 2012)

7. Joseph R.V. Romano, Romano Brothers & Co. (March 31, 2012)

Alphabetical List of Written Comments
Regulatory Notice 12-42

1. Michael Nicholas, Bond Dealers of America (December 20, 2012)

2. Lee A. Pickard and William D. Edick, Pickard and Djinis LLP (December 20, 2012)

3. Kurt N. Schacht and Linda L. Rittenhouse, CFA Institute (December 7, 2012)

4. Robert J. Stracks, BMO Capital Markets (December 20, 2012)

5. Kevin A. Zambrowicz, SIFMA (January 4, 2013)

Exhibit 2c

Public Investors Arbitration Bar Association

April 2, 2012

Via Email Only
pubcom@finra.org

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

Re: Regulatory Notice 12-09; Debt Research Reports

Dear Ms. Asquith:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure.

Regulatory Notice 12-09, represents a year's worth of comments and research put forth in response to Regulatory Notice 11-11. Regulatory Notice 12-09 is an improvement of Reg. Notice 11-11, and proposes to apply safeguards and disclosure requirements to the publication and distribution of debt research reports. PIABA generally support the proposal and believes that the proposed rule is a long overdue step in the right direction.

Although Regulatory Notice 12-09 is an improvement to Reg. Notice 11-11, it leaves noteworthy gaps. PIABA believes that disclosure is paramount to the functioning of a fair and efficient free market. Without consistent and disseminated information on conflicts of interest on all research for all debt securities, the marketplace will continue to function in the conflict-laden way it now operates. This necessarily is detrimental to both retail and institutional investors. Research reports have long been used for both debt and equity securities. Without a regulatory requirement, many firms failed to adhere to the "Guiding Principles." FINRA needs to do more to protect investors especially in light of Wall Street's increasing use of complex, risky debt products (mortgage backed securities, CDOs, auction rate securities, structured debt products, reverse convertibles, etc.). A framework is needed to properly regulate the research of debt securities.

It is unfortunate that the proposal excludes "municipal securities" from the definition of "debt security." It is PIABA's belief that FINRA has not adequately demonstrated why municipal securities (and the research related to them) should be afforded different treatment from other debt securities. FINRA should not rely on a jurisdictional limitation in excluding municipal securities from the proposed rule. To ensure market integrity, municipal securities must be covered by the proposed rule. FINRA should do more -- not less -- to ensure all investors are provided with fair, honest, and trustworthy information with respect to municipal securities.

PIABA believes that FINRA has also mistakenly excluded another large segment of debt securities from the definition of "debt security" which are "security-based swaps". FINRA should take this opportunity to be on the forefront of rulemaking to strip the cloak away from the high-stakes, opaque and destabilizing swap market. As of June 2010, the swap market constituted nearly two-thirds of the $583 trillion over-the-counter derivatives market[1]. In a market short on regulation, FINRA should use this opportunity to protect the investing public. The swap market played a role in the financial crisis and impacted both retail and institutional investors. Several income mutual funds became enamored with the higher returns derivatives and swaps provided, paying little or no attention to the speculative risk taken. The damage caused by these funds, and the swaps and derivatives they invested in, provides FINRA with all the reason it should need to supervise this complex market. PIABA hopes FINRA will reconsider and conclude that an exemption for this portion of the market should not exist in the proposed rule.

PIABA supports FINRA in opposing the exclusion from the rule of research related to sales to only institutional investors which FINRA has recognized left a large hole in the information marketplace.

PIABA is supportive of FINRA's effort and remains hopeful that FINRA will better serve investors by closing the loophole provided to municipal securities and swaps. We appreciate the opportunity to comment on the process.

Very truly yours,

Ryan K. Bakhtiari
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[1] *See* Pravin Rao and Assad Clark: "Securities & Commodities Regulation, Changing Landscape of Swap Regulation", Vol. 44, No. 8. April 20, 2011.

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SAN FRANCISCO 94104
(415) 421-8900

April 5, 2012

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

Dear Ms. Asquith:

Thank you for the opportunity to comment on a proposed rule regarding debt research reports, which was outlined in Regulatory Notice 12-09. Wulff, Hansen & Co. is a registered broker/dealer and FINRA member. The writer currently serves on FINRA's Small Firm Advisory Board but the views and comments expressed herein are those of the firm and do not necessarily reflect those of the SFAB.

We believe that the proposed Rule is redundant and unnecessary. It attempts to address practices which are already prohibited under the securities laws and a number of current FINRA and SEC rules and regulations. It also includes many new prohibitions, which are a solution in search of a problem: The debt markets are not the equity markets, and research is not produced or used in the same way.

In justifying the proposal, FINRA cites a number of egregious abuses which have occurred in the past. Anyone who doubts that such practices are already prohibited need look only at the scores of disciplinary actions and settlements which have resulted from the cited conduct. If the conduct were not prohibited under the current regime, it seems unlikely that the millions of dollars in fines and other sanctions could have been imposed.

That said, if a new rule must be made, it should be reasonable, balanced, and should reflect the realities of the fixed-income marketplace. It should not impair the ability of firms, whether large or small, to serve their investor and issuer clients by providing services (e.g., color and commentary) which are desired by those constituencies. It should not impair the ability of firms to use their most well-informed staff when applying the suitability rules. The current proposal fails all of these tests.

Many comments were made on earlier versions of this proposal. We agree with a number of them, but would like to associate ourselves particularly with the letter dated April 29, 2011 from DA Davidson, Merriman Capital, and ThinkEquity LLC in response to Regulatory Notice 11-11. Their letter expresses our own position on many of the issues raised by the proposal.

The remainder of this letter will address only certain issues pertaining to small firms, which FINRA defines as those with fewer than 150 registered persons. Many of those firms have fewer than ten such persons.

Small Firms

The proposal contains a limited exemption from a few of its provisions for firms doing a minimal amount of investment banking business. The exemption is a step in the right direction but as written will likely have the presumably unintended consequence of prohibiting many small firms from producing anything which meets the over-broad definition of 'debt research', and as a consequence make it impossible for them to serve their customers properly. Further, to the extent firms were forced to limit their activities in order to retain the exemption, it would complicate and perhaps doom the efforts made by many issuers and institutional investors to act in a socially responsible way by supporting small firms meeting various criteria.

Specifically, the criteria for the exemption are set too low, and the proposal fails to fully address the fact that many, probably most, small firms are not in a position to segregate responsibilities to the extent required by the proposed Rule even where the exemption can be used.

Transaction Threshold

With regard to the number of transactions allowed before the exemption is lost, it fails to recognize that many small firms participate in underwriting groups formed by much larger firms. This is particularly true where issuers wish to support small firms with various characteristics (minority, gender, size, location, etc.) and request that the senior manager include such firms as co-managers. Institutional customers also support the appointment of such firms as co-managers, as their inclusion may assist the institution in meeting its own criteria with regard to doing business with such entities. While the small firm may technically be a 'co-manager', it generally has little or no influence over the terms, timing, marketing, or any other aspect of the transaction. Therefore, we suggest that any volume-based exemption be measured by transactions where the small firm acted as Sole Manager. Simply having been 'along for the ride' on someone else's deal should not influence a firm's eligibility for the exemption. The proposal also fails to reflect that some small firms may engage in many transactions that are very small, and a threshold of ten may be too low. A single $100 million transaction is surely more significant than ten $1 million transactions, but the proposal does not reflect this fact.

Revenue Threshold

In addition, we believe that the $5,000,000 threshold is much too low. We are not in a position to judge whether that is an appropriate level for the equity markets (we doubt it, since the figure in Rule 2711 includes debt transactions as well as equity), but for the debt markets we are certain it should be larger. By way of illustration, SIFMA figures indicate that total U.S. equity issuance in 2011 was $198.3 billion. A firm doing only equity business and generating $5 million in revenue from these transactions could be receiving 0.0025% of the gross transaction volume before losing the exemption. For debt securities, excluding Treasuries and municipals, 2011 issuance was $1,178 billion. Applying the same percentage of gross transactions, a small firm doing only debt business should be allowed $29.7 million in revenue from these debt transactions before losing the exemption. The fact is that debt transactions are larger and more numerous than are equity transactions, and any volume- or revenue-based standard should reflect this fact. There are many other ways to address this issue (market share comes to mind, but we lack access to the necessary data), but it should be addressed in some manner.

Segregation and Firewalls

Even where able to meet the exemption criteria, many small firms would find it impossible to comply with the still-applicable portions of the proposed Rule. As we understand it, there is no exemption from some of the requirements that certain types of interaction, communication, and supervision among persons performing various functions be severely restricted.

In small firms, the same person often performs multiple functions. This is unavoidable. A single person may engage in both investment banking and trading. The same person may generate research for the firm's internal use or for its customers. This is an inescapable fact in the small-firm environment, particular in those where the entire spectrum of activity is performed by only a handful of people. In addition, small firms are often owned by their employees. This means that such persons will receive compensation or other financial benefit from all of these areas. FINRA has recognized these facts in the past, specifically in the 'Limited Size and Resources' exemption from certain aspects of its supervisory rules.

We urge in the strongest terms that some similar accommodation be made to reflect the fact that in small firms the same people are forced to wear multiple hats. The trader who is also a banker will inevitably talk to himself. There is no way to prevent this. Such an accommodation could include a number of safeguards designed to prevent abuse of the exemption. We would be happy to make a number of specific suggestions along those lines should FINRA accept the concept that certain barriers, whether firewalls, Chinese walls, or some other sort of walls, are not only unduly burdensome but in many cases literally impossible to construct in a small-firm environment. We believe that the limited size and resources exception in Rule 3012 has served its purpose well and have not seen any evidence that it has resulted in abuse or contravention of the purpose of the Rule. A similar exemption in the proposed Rule would allow small firms to continue to provide clients, whether investors or small issuers, with services that larger firms may be unwilling to render.

Respectfully submitted,

Chris Charles
President

sifma

Invested in America

April 2, 2012

Exclusively via e-mail to pubcom@finra.org

Ms. Marcia E. Asquith
Office of Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: **Comments Regarding FINRA's Proposed Rules to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports (FINRA Regulatory Notice 12-09)**

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("SIFMA")[1] is submitting this letter to the Financial Industry Regulatory Authority, Inc. ("FINRA") in response to FINRA's request for comments regarding a proposal to apply objectivity standards and disclosure requirements to the publication and distribution of debt research reports, as set forth in FINRA Regulatory Notice 12-09 and the accompanying proposed rule text (the "Proposed Rule"). SIFMA welcomes the opportunity to respond to FINRA's Proposed Rule.

I. Introduction

As an initial matter, SIFMA appreciates FINRA's extensive efforts to obtain input from both sell-side and buy-side firms regarding debt research and the role that debt research analysts play in the fixed income markets. SIFMA also appreciates FINRA's issuance of a concept proposal in advance of the Proposed Rule, in order to solicit comments from market participants. Many of the revisions to the concept proposal, which appear in the Proposed Rule, appear to be carefully tailored to take into consideration the key differences between the debt and equity markets and the nature of debt research.

SIFMA, however, continues to have concerns about certain aspects of the Proposed Rule. In particular, we believe that the following areas should be modified or clarified:

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1 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

- Definition of "Debt Security": The definition of "debt security," which does not exclude investment grade sovereign securities (other than U.S. Treasury securities), agency securities, or derivatives;

- Definition of "Research Report": The definition of "research report," which is not fully aligned with the definition of "research report" in Regulation AC, and could capture many routine sales and trading communications;

- Prohibitions on Pre-publication Review: The prohibition on any review of debt research reports by certain non-research personnel for factual verification or other legitimate purposes, which goes beyond the restrictions for equity research in NASD Rule 2711;

- Research Budget Considerations: The prohibition on considering specific revenues or results derived from investment banking or principal trading activities in making research budget decisions;

- Analyst Compensation and Evaluation Considerations: The prohibition on the consideration of any contributions to principal trading activities in making compensation decisions, and any input into analyst evaluations by principal trading personnel;

- Content and Disclosure Requirements: Certain broadly-worded provisions in the content and disclosure requirements;

- Institutional Research: An affirmative, written "opt-out" requirement in order to rely on the institutional research framework; and

- Third-Party Research: Certain provisions relating to third-party research, which are not consistent with the third-party research provisions in NASD Rule 2711.

We believe that these proposed modifications and clarifications, which are discussed more fully below, are critical to preserve necessary interactions between research and non-research personnel and to permit research management to make well-informed decisions regarding firms' and customers' research needs. Given the many safeguards built into the Proposed Rule, we believe these changes would not diminish the important goals of investor protection and integrity of research, which the Proposed Rule is designed to achieve. SIFMA's comments are organized to respond to the order of issues in the Proposed Rule, and do not necessarily reflect their order of importance.

II. Definitions

A. "Debt Security"

The Proposed Rule would apply to any person who prepares a research report on a "debt security." The Proposed Rule defines the term "debt security" as any "security" except for any "equity security," "municipal security," "security-based swap," and "U.S. Treasury Security."

Ms. Marcia E. Asquith
Page 3
April 2, 2012

While SIFMA appreciates FINRA's exclusion for U.S. Treasury securities, we believe that investment grade government securities should be excluded from the definition of "debt security."[2] Like U.S. government securities, these securities are obligations of major nations or their agencies and instrumentalities. Also, like research on U.S. government securities, research on non-U.S. sovereign securities is more macroeconomic in nature and less likely to raise the potential conflicts that the Proposed Rule is designed to address. Markets for investment grade sovereign securities are deep and liquid, and the publication of research analyst views is unlikely to affect those markets in any meaningful way. Further, like U.S. government securities, many investment grade sovereign securities are traded and analyzed by investors as rate products rather than as debt instruments. Based on these considerations, we request that FINRA exclude non-U.S. investment grade government bonds from the definition of "debt security."

Additionally, SIFMA requests that U.S. government agency debt and agency mortgage-backed securities (collectively, "Agency securities") should be excluded from the definition of "debt security." Agency securities are traded and analyzed by investors as rate products rather than as debt instruments. Accordingly, the type of analysis and considerations that generally apply to corporate debt instruments (primarily the creditworthiness of the issuer) do not apply to Agency securities. The main drivers for the price of Agency securities are movement in interest rates (as represented by Treasuries or interest rate swaps) and, in the case of mortgage-backed securities, the rate of prepayment of the underlying loans. Agency securities present a high degree of fungibility with U.S. Treasury securities (especially at the shorter-dated end of the curve, where they may trade nearly flat to U.S. Treasury securities). Further, the depth of this market, similar to that of U.S. Treasury securities, is such that no single analyst's views are likely to affect such market in a meaningful way. For these reasons, SIFMA requests that FINRA also exclude Agency securities from the definition of "debt security."

Finally, SIFMA asks that FINRA clarify that "derivatives," as defined in the research conflicts of interest rules of the Commodity Futures Trading Commission ("CFTC"), are excluded from FINRA's definition of a "debt security."[3] We assume that it was not FINRA's intent to include derivatives that would be regulated by the CFTC's research rules and we believe that such a carve out is appropriate because these reports would be subject to, and governed by, a federal scheme of regulation.

B. "Debt Research Report"

The Proposed Rule defines a "debt research report" as "any written (including electronic) communication that includes an analysis of debt securities and that provides information reasonably sufficient upon which to base an investment decision."[4] This definition excludes the communications excepted from the definition of "research report" in NASD Rule 2711(a)(9). While we endorse FINRA's application of the Rule 2711(a)(9) exceptions to debt research, we

2 As a standard for determining which securities are investment grade, SIFMA proposes one derived from Exchange Act Rule 15c3-1(c)(2)(vi)(F)(1), which would include debt securities rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations. Should the SEC eventually develop an alternative to this benchmark, FINRA could adjust this standard accordingly.

3 *See* 17 C.F.R. §§ 1.71(a)(4), 23.605(a)(4).

4 Subsection (a)(3) of the Proposed Rule.

Ms. Marcia E. Asquith
Page 4
April 2, 2012

ask that FINRA provide certain additional exclusions and conform the definition of "research report" in the Proposed Rule to the SEC's definition in Regulation AC.

We assume that FINRA intended the definition of "research report" in the Proposed Rule to be consistent with the definition of "research report" in Rule 500 of Regulation AC, which defines a "research report" as a "written communication (including an electronic communication) that includes an analysis of *a security or an issuer*" (emphasis added). Accordingly, we ask that FINRA revise the definition of "research report" in the Proposed Rule to focus on an analysis of "a security or an issuer," as opposed to "an analysis of debt securities" (which, if interpreted broadly, could cover an analysis of a class of debt securities that does not analyze an individual security or issuer). In addition, we ask that FINRA adopt all of the general exclusions from the definition of "research report" that were endorsed by the SEC, in particular the exclusion for "reports commenting on or analyzing particular types of debt securities or characteristics of debt securities" that do not include an analysis of, or recommend or rate, individual securities or companies.[5] We ask FINRA to include this exclusion in the rule text or, alternatively, in the discussion of the rule, to ensure consistency with the Proposed Rule and Regulation AC.

In addition, we believe it is important to provide limited exclusions for certain communications by sales and trading personnel that are common in the debt markets, particularly where those communications are sent only to institutional investors. While we fully understand FINRA's resistance to providing an across-the-board exemption for trader commentary based on the department of origin, we feel strongly that narrower exceptions, which are more specifically tailored to the debt markets, are necessary in order to meet the needs of both market participants and investors, who value information provided by non-research personnel. For example, an e-mail sent from the sales and trading desk to fifteen or more institutional clients highlighting a particular bond and providing a reasonable basis for a trading decision should not, in our view, amount to a debt research report. While SIFMA appreciates the tiered approach for institutional debt research, the current proposed structure does not provide the relief we that believe was intended because certain institutional-only material produced by non-research personnel may, nevertheless, be deemed "research" depending on their content, and therefore would be subject to the restrictions that apply to institutional research. Accordingly, we encourage FINRA to consider additional exclusions, which should be tailored so as not to create a "loophole" through which "biased and non-transparent research could be disseminated to *retail investors*."[6]

III. <u>Prohibition on Prepublication Review of Debt Research Reports by Certain Non-Research Personnel</u>

Subsection (b)(2) of the Proposed Rule would require firms to adopt policies and procedures that prohibit pre-publication review, clearance, or approval of debt research reports by persons involved in sales and trading, principal trading, or investment banking. While SIFMA agrees that there should be restrictions and controls around the review of research by non-research personnel, a flat prohibition on such review by these personnel goes beyond the

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5 *See Regulation Analyst Certification*, 68 Fed. Reg. 9482, 9485 (Feb. 27, 2003).

6 Regulatory Notice 12-09, at p. 4 (emphasis added).

well-established and balanced framework in NASD Rule 2711 for permitting non-research personnel to review research reports. For this reason, SIFMA asks that FINRA revise subsection (b)(2) so that it is consistent with the provisions regarding prepublication review of research reports in NASD Rule 2711.

In this regard, non-research personnel such as sales, trading, and investment banking can often perform an important role in reviewing research reports for factual verification. For example, for research on new complex structured products, analysts often need to interact with sales and trading desks, or origination or banking personnel, to verify that the basic facts about the products are correct. More generally, analysts rely on the expertise of sales and trading personnel to corroborate that their statements are accurate where research references market and trading activity, prevailing market prices, or yields. As long as there are controls and safeguards in place to monitor such reviews for potential conflicts or inappropriate input (similar to those in NASD Rule 2711), SIFMA does not believe that there is any reasonable justification for prohibiting this review, and the benefits of such reviews clearly outweigh the risks if such restrictions and controls are adopted.[7]

IV. Prohibition on Considering Specific Revenues or Results in Making Budget Decisions

Subsection (b)(3)(B) of the Proposed Rule would prohibit senior management from considering specific revenues or results derived from investment banking services or principal trading activities in determining the research budget. While SIFMA agrees that research budget decisions should be made by senior management, we also believe it would not be feasible for senior management to make accurate and appropriate research budget decisions if they were unable to consider trading and investment banking revenues in doing so. For these reasons, SIFMA urges FINRA to permit the consideration of principal trading and other business revenues in making budget decisions.

Fixed income research is not self-funded. It relies on funding from other areas of the firm to operate, and particularly on funding from sales and trading departments. During the budgeting process, senior management must assess requests regarding the hiring of new analysts and the allocation of research resources across a variety of markets and disciplines. Allowing non-research personnel to articulate the demand for debt research, including product trends and customer interests, but not permitting senior management to validate those demands on the basis of historical or prospective revenues, will inevitably result in a mismatch between research

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[7] *See* NASD Rule 2711(b)(3). Under Rule 2711, non-research personnel may review a research report before publication to verify factual information or identify conflicts of interest, provided that written communications between research and non-research personnel about the research report are made through legal or compliance personnel (or copied to them), and that any oral communication between research and non-research personnel about a research report is documented and made either through or in the presence of legal or compliance personnel.

department funding and actual customer needs.[8] The allocation of resources to specific sectors or areas (*e.g.*, for asset-backed research or high-yield research) is necessarily, and should continue to be, aligned with the importance of those areas to a firm's franchise and its sales, trading, and investing customers. The relative importance of one area over another (*e.g.*, asset-backed v. high-yield research) can only be measured by the revenues attributed to those areas that are generated by the firm's various business lines (*e.g.*, asset-backed v. high yield sales, trading, and banking revenues). For example, if revenue from banking, sales, and trading is down, or expected to be down, 20% for mortgage-backed securities, but up 10% for high-yield corporate bonds, senior management should be permitted to consider all of these revenue lines in determining whether additional resources are needed to cover high-yield research.

Finally, SIFMA believes that allowing consideration by a firm's senior management of all business revenues in setting the research budget would not undermine the integrity of research. There are many safeguards in the Proposed Rule designed to ensure that decisions regarding the allocation of research resources are insulated from inappropriate pressure from either investment banking or principal trading, including: (i) the requirement that budget decisions be made by senior management, which may not include investment banking or principal trading personnel; and (ii) the proposal that prohibits analysts' compensation from being tied to specific trading or investment banking transactions. Given these safeguards, it is not clear what benefit would be served or what harm would be cured by further prohibiting senior management's consideration of all revenue streams. SIFMA therefore asks FINRA to permit the consideration of principal trading and other business revenues in making budget decisions.[9]

V. **<u>Prohibitions Related to Analysts' Compensation and Evaluations</u>**

Subsection (b)(3)(C) of the Proposed Rule would prohibit compensation based upon specific investment banking services, specific trading transactions, or contributions to a member's investment banking services or principal trading activities. Also, under subsection (b)(3)(D), sales and trading personnel (but not personnel engaged in principal trading activities) may provide input into the evaluation of debt research analysts in order to convey customer feedback, provided that final compensation determinations are made by research management.

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8 Similar restrictions on input into budget by investment banking personnel have not worked well under the terms of the Global Research Settlement. *See* relevant orders in *SEC v. Bear, Stearns & Co., Inc.*, 03 Civ. 2937 (WHP) (S.D.N.Y.); *SEC v. Lehman Brothers Inc.*, 03 Civ. 2940 (WHP) (S.D.N.Y.); *SEC v. U.S. Bancorp Piper Jaffray Inc.*, 03 Civ. 2942 (WHP) (S.D.N.Y.); *SEC v. UBS Securities LLC*, 03 Civ. 2943 (WHP) (S.D.N.Y.); *SEC v. Goldman, Sachs Co.*, 03 Civ. 2944 (WHP) (S.D.N.Y.); *SEC v. Citigroup Global Markets Inc.*, 03 Civ. 2945 (WHP) (S.D.N.Y.); *SEC v. Credit Suisse First Boston LLC*, 03 Civ. 2946 (WHP) (S.D.N.Y.); *SEC v. Morgan Stanley*, 03 Civ. 2948 (WHP) (S.D.N.Y.); *SEC v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 03 Civ. 2941 (WHP) (S.D.N.Y.); *SEC v. Deutsche Bank Securities Inc.*, 04 Civ. 6909 (WHP) (S.D.N.Y.); *SEC v. Thomas Weisel Partners LLC*, 04 Civ. 6910 (WHP) (S.D.N.Y.) (collectively, the "Global Research Settlement"). These rules have led to immense difficulty in making budget and hiring determinations, and have produced frequent mismatches between the research department capabilities and the needs of the firm and firm customers who participate in offerings. SIFMA hopes that similar outcomes can be avoided under FINRA's rules for debt research.

9 Although we acknowledge that the Proposed Rule would permit sales revenue to be considered in making budget decisions, as a practical matter, because clients pay firms when transacting trades and not when talking to sales, it may not be feasible to separate sales revenue from trading revenue.

Ms. Marcia E. Asquith
Page 7
April 2, 2012

SIFMA agrees that final compensation determinations should be made by research management, based on specific factors, as applicable. SIFMA also agrees that there should not be formulaic connections between analysts' compensation and profits and losses on specific investment banking and sales and trading deals and transactions. However, the broad prohibitions on considering (i) the input of principal trading personnel, and (ii) *any* contributions to a member's principal trading activities go beyond the balanced and well-established provisions in NASD Rule 2711. They do not recognize that principal traders are a key source of contact with customers, and often may be the principal contact that a customer has with the firm. Nor do they take into account that many fixed income personnel may wear multiple "hats" (*e.g.*, a single person may be responsible for trading for a firm's account and engaging in sales activities). Because the vast majority of debt trading is conducted on a principal basis, by necessity and by function of the market, these prohibitions do not acknowledge the important role that debt analysts play in acting as a resource to desks that are serving critical functions in providing liquidity to the market and facilitating customer orders (*e.g.*, market making and customer facilitation trading desks). For these reasons, and as described more fully below, SIFMA urges FINRA to modify these prohibitions and adopt a standard that permits research management and the compensation committee to consider analysts' contributions to principal trading activities and solicit the views of principal trading personnel on analyst compensation and evaluations, provided that research management and the compensation committee maintains exclusive authority over final decisions. If there is a concern about particular types of feedback, we encourage FINRA to restrict or prohibit that feedback, and not the persons providing it. However, if FINRA disagrees, SIFMA asks that the restriction on input from principal trading extend only to those principal trading activities that have no client or customer-facing responsibilities.

Principal trader input into analyst compensation and evaluations is critical because, in the fixed income markets, principal trading personnel regularly interface with customers and therefore are a necessary resource for providing customer feedback on the quality and productivity of debt research analysts. This input is particularly important because certain benchmarks that may be used to determine compensation in the equity research context are inapposite or not present in the fixed income context. For example, unlike with equity research, fixed income analysts do not have "price targets" for their bonds, and may not have estimates for companies they cover, so there are fewer objective bases to measure the accuracy of their research. Additionally, because fixed income research coverage is periodic and analysts cover thousands of bonds (unlike equity research), it is impossible for research management to determine the "quality of an analyst's research" without obtaining input from all constituencies with whom the analyst interacts—including principal trading personnel. Also, there is no mechanism for retail customers to provide comprehensive views on research, and there is limited ability for institutional customers to provide formalized feedback regarding the quality of any research product. In this regard, there are only a small number of surveys and broker votes relevant to fixed income research.[10] For these reasons, principal trading and other non-research personnel play a critical role in passing customer feedback along to research management. To

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10 Even for equity research, the amount of detailed information contained in broker votes varies widely among customers, with many providing limited feedback and others providing no broker votes at all. So, by necessity, broker vote information is only one element considered when assessing the customer impact of equity analysts.

this point, it is worth noting that in its recently-adopted research analyst conflicts of interest rules, the CFTC recognized the legitimacy of this role, and adopted a provision that allows customer indicators of analyst performance to be passed to research management by all trading and other business personnel, provided that research management is responsible for final decisions.[11]

It is also important for analysts' contributions to principal trading activities to be considered by research management and compensation committees. Research analysts' ability to offer articulate and insightful analysis to trading desks is a significant part of their roles at firms. To this end, traders rely heavily on debt research and research analysts to help them better understand the terms of and risk factors associated with specific bonds, so that they are better able to assist customers in making informed investment and trading decisions. Traders and trading management also rely on research analysts to help them manage risk related to firm positions, and to facilitate customer trades through market making and counterparty transactions. The nature of the debt markets requires firms to act in a principal capacity to facilitate customers' trading. Firms with significant debt franchises are required to carry on their books debt securities or instruments representing many issuers and classes of securities in order to facilitate ordinary customer trading flows. To assist them in better managing risk and firm positions and facilitating customer transactions, traders will often talk to research analysts to more fully understand an issuer's debt capital structure and how macroeconomic and market factors may affect the issuer's different classes of bonds. For these reasons, debt analysts spend a considerable amount of time interacting with trading personnel. It would not be fair if research management could not take this time and effort into account in making compensation and evaluation decisions.

Putting aside these legitimate reasons for allowing research management to consider contributions to principal trading activities and allowing the input of principal trading personnel, SIFMA does not see any discernible investor protection benefit in prohibiting such consideration or input. To this end, there are important safeguards that FINRA has proposed for retail research that would promote research analyst independence and quality with respect to compensation considerations. These safeguards, which SIFMA fully supports, include the following: (i) research management shall be responsible for final decisions regarding evaluations and compensation; (ii) debt research analysts shall not be compensated based on the success of or revenues derived from specific sales and trading transactions; and (iii) research analysts' compensation shall be reviewed and approved by a compensation committee, which will consider the quality of the research product, and will serve as an important bulwark against inappropriate influence of sales and trading personnel into compensation decisions. These

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11 *See* 17 C.F.R. §§ 1.71(c)(3), 23.605(c)(3). As originally proposed, the CFTC's rule would not have permitted such input. Based on concerns raised by SIFMA and other commenters, the CFTC modified its proposed rules to permit personnel of business trading units and clearing units to "communicat[e] client or customer feedback, ratings and other indicators of research analyst performance to research department management." *See Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer*, at pp. 97-99, *available at* http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister022312b.pdf (not yet published in the Federal Register as of the date of this letter).

important safeguards have worked well in the equity context, and will help assure that decisions relating to debt research are not inappropriately influenced by other areas of the firm.

SIFMA is not aware of instances or examples that would justify a complete prohibition on research management's consideration of analysts' contributions to the firm's principal trading activities or the input of principal trading personnel. For the reasons set forth above, we believe that any measurable investor protection benefit derived from these prohibitions would be greatly outweighed by the costs of prohibiting important constituencies from providing feedback regarding research.

VI. Content and Disclosure in Debt Research Reports

A. "All Conflicts"

Subsection (c)(5) of the Proposed Rule requires members to disclose in any debt research report "*all conflicts* that reasonably could be expected to influence the objectivity of the debt research report and that are known or should have been known by the member or debt research analysts on the date of publication or distribution of the report" (emphasis added).[12]

This "all conflicts" standard is not present in NASD Rule 2711, and could be interpreted very broadly. Read literally, this language would require members to engage in a sweeping exercise to identify—with respect to every research report—*all* possible conflicts (material or immaterial) that may be known to anyone at the member. Compliance with such a standard is simply not possible. The proposed language also assumes that conflicts could be expected to and do influence the objectivity of research reports, even though FINRA's existing research analyst rules and Regulation AC assume the contrary, *i.e.*, that potential conflicts can be managed using disclosures and certifications in order to preserve the objectivity of research analysts and research reports. Further, it is not clear which types of conflicts this standard is intended to capture beyond those conflicts covered by subparagraph (c)(5)(H) (which requires disclosure of "any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of publication or distribution of the report").

For these reasons, SIFMA asks FINRA to either (i) specify the types of conflicts that it intends to capture by this new provision, or (ii) maintain the standard in Rule 2711, which includes a known "actual, material" conflict standard, as opposed to an "all conflicts" standard.

B. "Or Distribution"

Subsection (c)(5)(H) applies the "catch all" material conflicts disclosure requirement to conflicts that are known (or where there is reason to know) at the time of publication *or distribution* of the research report.[13] In contrast, NASD Rule 2711(h)(1)(C) only applies at the

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[12] In this respect, the Proposed Rule is consistent with proposed FINRA Rule 2240(c)(5), which we noted is similarly problematic in our comment letter of November 14, 2008 ("2008 Comment Letter").

[13] The Proposed Rule is also consistent with proposed FINRA Rule 2240(c)(5) in this respect, which we believe is similarly problematic, as discussed in our 2008 Comment Letter.

time of "publication of the research report." This "or distribution" standard is a much broader standard and not reflective of the conflicts of interest that apply at the time the analyst writes the research report. This standard is also problematic because it could require members to delay the distribution of any research reports until they have surveyed any persons who have the "ability to influence the content of the research report" to determine whether such persons "know or have reason to know of any material conflicts."

Further, it is unclear how members could control and prevent the distribution of reports that already have been published, in order to determine whether additional disclosures are required. For example, if a member publishes a report, does it need to monitor and prevent any subsequent mailings of that report by its salespeople or other associated persons and, potentially, include additional disclosures in those reports? We do not believe such a requirement would be practical or useful to investors. Indeed, to the extent any potential conflicts of interest arise after the publication of a report, such conflicts would not have influenced the substance or content of the report. For these reasons, SIFMA asks FINRA to modify the Proposed Rule so that it is consistent with the language that is currently in NASD Rule 2711(h)(1)(C).

C. **Requests for Clarification and Consideration**

SIFMA requests clarification of or further guidance on the following disclosure provisions.

- Subsection (c)(2) provides that "any recommendation or rating . . . be accompanied by a clear explanation of the valuation method used and a fair presentation of the risks that may impede the achievement of the recommendation or rating." SIFMA asks FINRA to clarify that the "valuation method" requirement only applies if the analyst utilized a formal valuation method (because some recommendations may not involve a formal valuation method, although in such cases the recommendation would remain subject to the reasonable basis requirements).

- Subsection (c)(3)(A) states that a member employing a rating system must include in its debt research reports "the percentage of all securities rated by the member to which the member would assign a 'buy,' 'hold,' or 'sell' rating." SIFMA asks that the term "securities" in this provision be qualified as "debt securities."

- Subsection (c)(4) requires "rating tables" if a debt research report contains a rating for a debt security and the member has assigned a rating for that debt security for at least one year. SIFMA asks FINRA to grant firms the flexibility to make a good faith determination of the universe of relevant securities that constitute a debt security for purposes of these ratings tables, given that bonds of the same issuer can and often do have different ratings.

- SIFMA asks FINRA to provide guidance regarding the difference between a "recommendation" and "rating" for purposes of the proposed disclosures. For example, if a debt analyst recommends a relative value or paired trade idea (*e.g.*, "Buy security X, sell security Y"), we believe this statement should be treated as a recommendation, but not as a rating on the individual securities (in the example, a "Buy" rating on X and a "Sell" rating on Y).

In addition, we ask that, in formulating the final disclosure provisions, FINRA consider providing firms with flexibility in making disclosures in debt research reports on sovereign issues. In this regard, tracking relationships with sovereign issuers will be challenging given the many and diverse relationships that firms may have, or seek to have, with governments. At the same time, the potential for inappropriate influence is significantly diminished for research on these issuers because research on non-U.S. sovereign securities is more macroeconomic in nature and, therefore, less likely to raise the potential conflicts that the Proposed Rule is designed to address. Further, the markets for many sovereign securities are deep and liquid, and the publication of research analyst views is unlikely to affect those markets in any meaningful way.

VII. Debt Research Reports Provided to Institutional Investors

A. Opt-out Provision

We appreciate FINRA's proposal of a tiered regulatory framework for research sent to retail and institutional investors. This framework is similar to the tiered framework currently in place under NASD Rules 2210 and 2211 for sales materials sent to retail and institutional investors. We also appreciate the important modifications that FINRA has made to the institutional research provisions, by focusing the prohibitions and restrictions on interactions between research and investment banking personnel. However, we are concerned that the requirement that member firms must obtain "affirmative written consent" from institutional investors in order to rely on the institutional research framework will be unduly burdensome and impractical to implement. We, therefore, urge FINRA to adopt the "opt-in" approach articulated in the concept proposal, *i.e.*, that fixed income research provided to institutional investors is exempted from many of the provisions applicable to research provided to retail investors, *except* where an institutional investor affirmatively opts in to the retail debt research framework in order to receive the more protective regime. In this regard, we believe that the additional costs and burdens of requiring eligible institutional investors to affirmatively choose the institutional debt research framework would exceed any benefit that an institutional investor would receive by being automatically included within the retail debt research framework (as under the Proposed Rule).

The proposed "opt-out" approach would be both burdensome and duplicative. It would be duplicative because firms already expend resources to obtain and document similar consents in connection with their suitability obligations and in identifying institutional investors' "Qualified Institutional Buyer" status for Rule 144A transactions. It also would be burdensome because firms would need to build additional systems and procedures to track clients who have not opted to receive institutional research. Specifically, firms would need to deploy new entitlement technology on their institutional research platforms, which does not exist for a similar purpose. This would involve the development and implementation of a mechanism to request, classify, and capture institutional client opt-out certifications, as well as the associated operations and relationship efforts required to explain the initiative and technology solution to clients. Firms would also need to develop logic and/or links between various institutional research reports and eligible institutional investors who have been deemed entitled to receive such research. For instance, a mechanism would need to be created that would allow clients who have not opted out of the retail debt research framework to continue to receive research about U.S. Treasury securities, but would block them from receiving institutional corporate debt research.

While we acknowledge that there would be client tracking requirements under the "opt-in" framework articulated in FINRA's concept proposal (which we prefer), these requirements would be far less onerous than those that would be imposed by the "opt-out" approach in the Proposed Rule, which would require firms to track and obtain certifications for *all* institutional clients who receive institutional research. As compared to the approach in the concept proposal, the approach in the Proposed Rule is also problematic because it would greatly hinder firms' ability to produce and distribute institutional research. Under the Proposed Rule, firms presumably would be required to cease any and all publication of institutional research until they obtained the required certifications. This would not be the case under the framework articulated in the concept proposal, whereby firms could continue to publish institutional research, but could not disseminate such research to customers that opt in to the retail research framework.

In addition to the costs and burdens described above, the proposed opt-out approach could lead to confusion or conflict in the distribution of institutional debt research within particular institutional investors. Even if a research department could develop the appropriate systems to affirmatively confirm that each institutional investor has opted in to the institutional investor regime under the Proposed Rule, which would only address the distribution of research from research departments, there would still be a substantial risk of confusion for sales forces as to which level of research could be distributed within institutional clients. In this regard, debt research is frequently distributed to institutional investors based on asset class, and is permissioned at the level of particular individuals within in institutional investor; that is, certain people within an institutional investor have permission to receive certain research, and the permission is not granted to the institutional investor as a whole. Under the proposed framework, firms could be required to collect affirmative written consents to receive institutional debt research from each of these individuals. On top of the burdens imposed by such intake and collection, there could be conflicting responses from within a single institutional investor, thereby creating additional tracking difficulties in the distribution of research.

SIFMA appreciates that there are differences in sophistication within the class of institutional investors. However, these differences are better addressed by the existing suitability rules. Research is not in and of itself a solicitation to engage in a trade, and if research were sent to a client who was not sophisticated enough to trade the product discussed, that should be determined on the basis of the suitability rules at the time the client chooses to engage in a trade. Also, unlike suitability determinations, which can more easily be made on a client-by-client basis and can be linked to specific firm trading systems, research is distributed more broadly, on a global basis. As such, it would be incredibly difficult to track and process all recipients who have affirmatively consented to receive it. Additionally, the Proposed Rule's requirement that the affirmation be in writing is more burdensome than the suitability rules, which do not have a similar requirement.

Finally, we believe the opt-out framework in the Proposed Rule is not necessary to protect institutional investors, given the (i) coupling of the conflict of interest provisions for institutional research in subsection (f)(2) with the required prominent disclosures, (ii) the ability of institutional investors to decline to receive institutional research, and (iii) the existing content standards in NASD IM 2210-1. Given these safeguards, we do not see any incremental benefit that the proposed opt-out regime would offer that would outweigh the costs of implementation. We believe that there is no need to broadly impose such costs, where the goal of affording elevated protections to institutional investors who desire them may be achieved with a more finely-tailored mechanism.

B. Required Disclosure

Under subsection (f)(3)(A), debt research reports provided only to eligible institutional investors must disclose on the first page that: "This research report is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors." SIFMA requests that FINRA permit firms to modify this disclosure, instead, to state "This document is intended for institutional investors . . . ." Such a modification would be appropriate, for example, where material is not produced by research department personnel, but rather sales and trading personnel.

VIII. Third-Party Research Reports

The Proposed Rule's provisions for third-party research are not consistent with NASD Rule 2711(h)(13) (third-party research). We ask that FINRA make these provisions consistent with the current framework in NASD Rule 2711 or clarify the scope of what the provisions are intended to capture. For example, Proposed Rule subsection (h)(1) requires firms to "establish, maintain and enforce policies and procedures reasonably designed to ensure that any third-party debt research report it distributes is reliable *and objective*" (emphasis added). This requirement to ensure that third-party research is "objective" does not appear in NASD Rule 2711(h)(13), and it is not clear what FINRA means by "objective" in this context. Further, subsection (h)(2) requires firms to "disclose any material conflict that can reasonably be expected to have influenced the choice of a third-party debt research report provider or the subject company of a third-party debt research report." This provision also is not in NASD Rule 2711(h)(13), and it is not clear what types of conflicts this provision is intended to capture.

IX. Broad Prohibitions on Interactions Between Research Analysts and Non-Research Personnel

A. Prohibitions on Interactions with Investment Banking Personnel

1. Joint Due Diligence

Supplementary Material .02 prohibits joint due diligence (*e.g.*, confirming the adequacy of disclosures in offering or other disclosure documents for a transaction) conducted with a company in the presence of investment banking department personnel. This provision goes beyond the prohibitions in the equity research framework, as well as beyond the requirements of the amended Global Research Settlement, which allows joint due diligence under certain conditions. To be sure, the Global Research Settlement was recently amended in recognition of the fact that a broad prohibition on *any* joint due diligence creates unnecessary inefficiencies and additional costs for firms. We do not believe there is any benefit to be gained by prohibiting debt research analysts from conducting joint due diligence with investment banking personnel, particularly if firms adopt policies and procedures to control any potential conflicts or pressures that may arise in the context of joint due diligence. Accordingly, we request that FINRA allow firms to permit analysts and investment banking personnel to jointly conduct due diligence, provided firms have such policies and procedures in place.

2. Requests for Clarification

Subsection (b)(2)(C)(i) of the Proposed Rule would require firms to prohibit analysts from "participating in pitches and other solicitations of investment banking services transactions." SIFMA asks FINRA to (i) provide guidance on what it intends to capture by this provision, or (ii) conform the prohibition to the more precise language in NASD Rule 2711, which prohibits analysts from "participating in pitches to prospective investment banking clients, or have other communications with companies for the purpose of soliciting investment banking business." We ask that, at a minimum, FINRA clarify the types of contacts that this provision is not intended to capture.

Subsection (b)(2)(C)(ii) of the Proposed Rule would require firms to prohibit analysts from participating in "road shows and other marketing on behalf of issuers." SIFMA asks FINRA to clarify that, consistent with NASD Rule 2711, this prohibition is only intended to cover road shows and other marketing "related to an investment banking services transaction," and not non-deal road shows. Alternatively, if this is not the intention, we ask FINRA to clarify the types of activity that are intended to be covered, and that non-deal road shows are not included. We also ask FINRA to clarify that debt research analysts may passively attend company-sponsored road shows where the presence of the analysts is not announced to other participants. SIFMA believes such passive attendance does not raise the concerns the Proposed Rule is designed to prevent. Restrictions on the ability of debt analysts to hear information from company management are particularly problematic in debt offerings because debt offerings often move very quickly and there may be few opportunities for analysts to obtain information directly from company management during the truncated offering process. Such passive participation is also consistent with NASD Rule 2711.[14]

B. Prohibitions on Interactions with Sales and Trading Personnel

Supplementary Material .04(a)(1) contains a general prohibition on "attempting to influence a debt research analyst's opinions or views for the purpose of benefiting the trading position of the firm, a customer, or a class of customers." SIFMA asks FINRA to clarify that this prohibition will not capture ordinary-course communications with research analysts, and that it is meant to act as a prohibition on non-research direction over the decision to publish a research report and on non-research direction over the views and opinions expressed in debt research reports. We note that such a clarification seems to accord with the intent of the

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14 *See* NASD Notice to Members 07-04, p. 4.

proposed language, and would be consistent with the CFTC's recently-adopted conflicts of interest rules for research analysts.[15]

Supplementary Material .04(a)(2) contains a general statement that debt research analysts are prohibited from "identifying or recommending specific potential trading transactions to sales and trading or principal trading personnel that are inconsistent with such debt research analyst's currently published research reports." SIFMA asks that FINRA codify, in this supplementary material, the guidance in Regulatory Notices 11-11 and 12-09, which provides that in assessing whether a debt research analyst's permissible communications are "inconsistent" with the analyst's published research, a firm may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the analyst's published views.

X. **Effective Dates**

Finally, implementation of many of the provisions in the Proposed Rule will require firms to build new systems, data feeds, and processes and will be time consuming to implement. In particular, compliance with the new disclosure rules likely will require a lengthy period of time to be put into place. SIMFA, therefore, requests that FINRA take these factors into consideration, and solicit comments from the industry, in determining the effective dates for the various provisions of the Proposed Rule.

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We appreciate the opportunity to comment on the Proposed Rule. We reiterate our support for many of the proposed provisions as well as our concerns with respect to others. We would be pleased to discuss any of these points further, and to provide additional information you believe would be helpful. Please feel free to contact me, at (202) 962-7373, if you have any questions or comments.

Sincerely,

Ira D. Hammerman
Senior Managing Director, General Counsel and Secretary, SIFMA

cc: Mr. Marc Menchel, Executive Vice President and General Counsel for Regulation, FINRA
Mr. Philip Shaikun, Associate Vice President, Office of General Counsel, FINRA
Ms. Racquel Russell, Assistant General Counsel, Office of General Counsel, FINRA

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15 The CFTC's rules provide that non-research personnel "shall not direct a research analyst's decision to publish a research report" and "shall not direct the views and opinions expressed in a research report." 17 C.F.R. §§ 1.71(c)(1)(i), 23.605(c)(1)(i).

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April 10, 2012

Via Email

Ms. Marcia E. Asquith
Office of Corporate Secretary
FINRA
1735 K Street, N.W.
Washington DC 20006-1506

Re: Comments Regarding FINRA's Regulatory Notice 12-09 "Debt Research Reports"; A Proposed New FINRA Rule "Research Analysts and Debt Research Reports" and Proposed Supplemental Materials to that Proposed New FINRA Rule

Dear Ms. Asquith:

Thank you for this opportunity to comment on behalf of Morgan Stanley & Co. LLC ("Morgan Stanley" or the "Firm") on Regulatory Notice 12-09, the Proposed New FINRA Rule regarding Research Analysts and Debt Research Reports (the "Proposed Rule"), and the Proposed Supplemental Materials (together, the "Proposal"). This letter supports the Securities Industry and Financial Markets Association ("SIFMA") in each of the points made in the letter SIFMA submitted on April 2 regarding the Proposal. The intent of this letter is to expand on some of those comments as they relate to the need for further refinement of the definition of "debt research report" that FINRA incorporates in any rule that it files with the SEC for approval. Morgan Stanley believes this is prudent to avoid potential unintended restrictions on the flow of market commentary, pricing dialogue and related communications that currently take place between member firm employees other than research analysts and investors.

The Firm would like to reiterate SIFMA's recommendation that the base definition of "debt research report" incorporate the concept from both the Regulation AC definition of research report and the Rule 2711 (and Rule 472) definition for equity research report, that a research report analyzes a specific security or an issuer (Regulation AC), or analyzes the equity securities of individual companies or industries (Rule 2711). As SIFMA has recommended, the proposed definition of "debt research report" should, at a minimum, state clearly that a debt research report is "any written (including electronic) communication that includes an analysis of a debt security or an issuer..."

Furthermore, the Firm believes that the definition of "debt research report" must recognize that certain sales and trading communications with institutional clients regarding debt securities should be more clearly excluded from the current proposed definition of "debt research report" because those communications are not intended, perceived, or used by recipients as "debt research reports."

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bingham.com

First, the Firm recommends that FINRA add an exception to the definition of "debt research report" for those communications that are institutional sales materials that form the basis for an on-going exchange of information with institutional investors. As described below, the nature of these communications is sufficiently distinct that they should not be inadvertently captured by the definition of "debt research report" even where they may share certain characteristics with "institutional debt research reports."

Second, the Firm requests that the Proposed Rule incorporate, as recommended by SIFMA, the exception from the definition of "research report" that the SEC provided in its release adopting Regulation AC for "reports commenting on or analyzing particular types of debt securities or characteristics of debt securities."[1] The proposed definition of "debt research report" currently would incorporate the exceptions from Rule 2711 that are *derived* from the Regulation AC exceptions, but the Rule 2711 exceptions are more limited than the SEC's list in the Regulation AC release. This, presumably, is because the SEC in adopting Regulation AC had to address situations where communications might discuss equity or debt securities, while NASD and NYSE in the context of Rule 2711 and NYSE Rule 472 only had to address communications that might discuss equity securities.[2] It is very important that a rule regarding debt research reports incorporates the SEC's exceptions from Regulation AC regarding communications about debt securities, in addition to those already incorporated into Rule 2711.

The Firm's comments are premised on the regulatory framework that has been in place since 2003 and earlier for communications about debt securities. Since 2003, SEC Regulation AC has applied to all FINRA members (and other regulated research providers) that produce or distribute debt research reports, as defined in Regulation AC. And FINRA's rules regarding communications for decades have required that any communication with an institutional investor satisfy certain standards.[3]

[1] Sec. Act Rel. No. 8193, Regulation Analyst Certification (Feb. 20, 2003) http://www.sec.gov/rules/final/33-8193.htm .

[2] NASD (as it then was) and NYSE first incorporated the Regulation AC exceptions by reference in the Joint Memorandum of NASD and The New York Stock Exchange that accompanied publication of NASD Notice to Members 02-39 and NYSE Information Memorandum 02-26, but did not include the exception for "reports commenting on or analyzing particular types of debt securities or characteristics of debt securities." This exception also was not included when the exceptions were later incorporated into NASD Rule 2711 and NYSE Rule 472, presumably because these rules only reference research reports on equity securities. See NASD Notice to Member 07-04 and NYSE Information Memorandum 07-11.

[3] These have been reiterated recently in Regulatory Notice 09-55, proposing consolidated rules regarding Communications, and in FINRA's subsequent filings with the SEC in connection with these consolidated rules. We note that FINRA's consolidated rules on Communications have been approved by the SEC but the effective date is not yet announced. See, Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No.

Firms such as Morgan Stanley have built compliance programs around these regulatory pillars, as well as regulatory concepts derived from FINRA Rule 2711 that have already been imported into debt research compliance programs, and these pillars have served the markets well. Changes that may be necessitated by certain aspects of FINRA's proposed revised approach to communications regarding debt securities will be unduly burdensome and costly, and could have the effect of reducing available market information to investors without commensurate public policy returns.[4]

The Firm commends FINRA for its efforts to date to understand the broad variety of communications between FINRA members and institutional investors in debt securities. Those communications contribute to the information flow and functioning of the fixed income markets in ways that are different from traditional research reports. Indeed, the Firm believes that such communications are distinguishable from research reports, by investors and firms alike, under the existing regulatory framework.[5] Furthermore, the Firm believes that institutional investors do not rely on these communications as the sole basis for investment decisions.

The Firm understands that FINRA is hesitant to grant a blanket exception that might permit content equivalent to a traditional research report to avoid the debt research rule's requirements simply based on where within a member's operations it is produced. However, the Firm believes that FINRA's current proposal lacks sufficient exclusions or

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(continued from next page)

3 and Order Granting Accelerated Approval of a Proposed Rule Change, as modified by Amendments Nos. 1, 2 and 3, to Adopt FINRA Rules 2210 (Communications with the Public), 2212 (Use of Investment Companies Rankings in Retail Communications), 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings), 2214 (Requirements for the Use of Investment Analysis Tools), 2215 (Communications with the Public Regarding Security Futures), and 2216 (Communications with the Public About Collateralized Mortgage Obligations (CMOs) in the Consolidated FINRA Rulebook, Release No. 34-66681, File No. SR-FINRA-2011-035, (March 29, 2012).

[4] Based upon the existing regulatory framework and the Guiding Principles to Promote the Integrity of Fixed Income Research (May 2004) (the "BMA Guidelines"), the Firm has developed policies and procedures with respect to market commentary and other sales and trading communications that presently are not considered research reports. The Firm believes that the compliance infrastructure that has been created around non-research communications is effective, without unduly restricting the flow of trading ideas and other security specific information between firm employees other than research analysts--particularly market-making and facilitation desks-- and interested institutional investors.

[5] The BMA Guidelines provided a guide to distinguish between trading desk communications and research that many FINRA firms used to build their compliance programs for non-research debt communications as well as debt research.

clarity to avoid potentially inadvertently capturing normal course sales and trading communications.

The Firm would welcome the opportunity to present current examples of the types of sales and trading commentary that is exchanged with institutional investors that it considers non-research communications. Generally, such communications are not viewed as targeted to an individual client (to which an exclusion in the Proposed Rule would apply). Rather, they may be provided to a large number of institutional investors, and in some cases are posted in electronic forums where those investors can access the content if and when they choose. These communications frequently make reference to one or more specific issuers, and/or specific debt securities or classes of debt securities of one or more issuers, and frequently include relative value (or yield) comparisons, pricing or market flow information, and the sales person or trader's opinion on one or more trades, or combination of trades. These communications, which are clearly marked as communications produced from a sales or trading desk, may discuss specific debt securities in depth and in detail but, the Firm believes, are generally understood and expected by institutional market participants to be part of broker-dealers' activities in seeking and providing liquidity.

Morgan Stanley understands and appreciates that FINRA has proposed the tiering of debt research reports in the hope that regulation of debt research reports sent to institutional investors will be sufficiently flexible to permit communications like those mentioned above to continue within the debt research rule. However, the Firm believes that the construct set forth in the Proposed Rule may not provide the flexibility we believe FINRA intended. The limitations imposed on institutional debt research could inhibit the ability of sales and trading personnel to convey information on a regular basis to institutional investors in a manner that allows ongoing dialogue relative to the instruments being traded. Without an exception from the definition of "debt research report" for these communications, a FINRA examiner reviewing email or other correspondence in hindsight might believe such communications satisfy the proposed definition of debt research report, applying a "reasonable investor" standard that is not truly applicable to how institutional investors use or understand such material (i.e., an examiner might read the materials and believe that there was information sufficient upon which to base an investment decision). [6]

[6] In addition, FINRA members' personnel routinely send out written communications, that, for lack of a better term, are "macro." These communications may emanate from a trading desk, research department or elsewhere in a firm, and discuss markets and/or economic factors generally, but as part of that discussion may identify individual debt securities, either as examples or as being particularly interesting in the context of the macro discussion, without significant detail. Such reports might similarly discuss events or trends that could impact particular markets, sectors or types of issuers, and reference some or all of those issuers and their debt securities. Without clear guidance, either in the form of an exception or interpretive guidance, such communications may be deemed debt research reports subject, at a minimum, to the restrictions applicable to institutional debt research reports.

Moreover, if these communications are defined as "debt research reports" under the Proposed Rule, additional SRO and SEC requirements likely would apply, which may make distribution of the materials impermissible without pre-review by a Series 16 or Series 24 licensed Principal. Such pre-review would require the development of substantial infrastructure that would be costly and overly burdensome, and would unnecessarily impede the timely flow of information in the debt markets. Further, the treatment of some normal course sales and trading commentary as debt research reports would raise uncertainty regarding the application of Regulation AC to these materials and the certification language that is fundamentally inapposite to such materials. The Firm believes these protections are not necessary for these communications with institutional investors and, in any event, any non-research communication must include the required prominent disclosures and comply with the existing content standards in NASD IM 2210-1, which provide ample safeguards to institutional clients.

Morgan Stanley believes the amendments to the Proposed Rule outlined earlier in this letter would serve to avoid unintended consequences and allow FINRA to maintain the controls over true research content that FINRA seeks to achieve. Morgan Stanley would welcome the opportunity to work with FINRA to develop a framework that more expressly recognizes the range of communications that discuss debt securities while preserving FINRA's policy objectives. Please do not hesitate to contact me at 202-373-6118 if you have any questions regarding the above.

Sincerely yours,

Amy Natterson Kroll

Amy Natterson Kroll

cc: Mr. Marc Menchel, Executive Vice President and General Counsel for Regulation, FINRA
Mr. Philip Shaikun, Associate Vice President, Office of General Counsel, FINRA
Ms. Racquel Russell, Assistant General Counsel, Office of General Counsel, FINRA

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April 2, 2012

VIA ELECTRONIC MAIL
Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K. Street, NW
Washington, DC 20006-1506

RE: Regulatory Notice 12-09: FINRA Requests Comment on a Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports

Dear Ms. Asquith:

Bond Dealers of America (BDA) is pleased to submit this letter in response to the Financial Industry Regulatory Authority's (FINRA) solicitation of comments in connection with FINRA's proposed rule relating to debt research reports (Revised FINRA Proposal). BDA is the only DC based group representing the interests of securities dealers and banks focused on the U.S. fixed income markets. The Revised FINRA Proposal will directly impact many of our members. Accordingly, we welcome this opportunity to state our position.

In general, we are concerned with FINRA's approach to developing a rule governing debt research reports. The markets have come to accept the *Guiding Principles to Promote the Integrity of Fixed Income Research* (Guiding Principles) published by The Bond Market Association in 2004 as the accepted standards governing fixed income research. In FINRA's Regulatory Notice 11-11, which conceptually proposed a rule governing fixed income research, FINRA did not state that its concern was that the Guiding Principles were not substantively adequate but rather that FINRA's concern was that firms were failing to implement the Guiding Principles or failing to ensure that they were being followed. FINRA has failed to show what abuses have occurred that justify such a dramatic shift from the substance of the Guiding Principles when dealers and investors alike have come to accept them and find them useful.

Institutional Investor Exception. Under the March 2011 concept proposal, an institutional investor had to elect to be treated as a retail investor for purposes of the debt research rules. The Revised FINRA Proposal reverses this and requires affirmative acknowledgement, in writing, by the institutional investor that it wishes to forego treatment as a retail investor. We oppose the opt-out approach of the Revised FINRA Proposal and strongly encourage FINRA to adopt the opt-in approach described in the March 2011 concept proposal.

While we recognize the need for investor protection, the imposition of the opt-out requirement would not further such purpose. FINRA's concern regarding the level of sophistication of certain institutional investors is misplaced, as institutional investors understand the difference between objective research and trading desk commentary and understand the kinds of inherent conflicts that can exist with research analysis generated by a dealer that is seeking to sell a position. The opt-in provision is going to require a substantial amount of paperwork and compliance efforts that are simply unnecessary and, based on what FINRA says in Regulatory Notice 12-09, does not appear to be sought after by the investors themselves.

Trading and Sales Reports. In Regulatory Notice 12-09, FINRA states that it declined to exclude trader commentary from the coverage of the Revised FINRA Proposal. However, the Guiding Principles themselves saw the need for trader commentary. We simply see no reason to essentially eliminate trader commentary from the fixed income markets as it is impossible for the trading desk itself to disseminate trader commentary and comply with the extensive restrictions contained in the Revised FINRA Proposal. Some firms place blackout requirements that prohibit their research analysts from disseminating research reports when the firm is underwriting the securities. The only kind of information that is sent to investors in these cases is trader commentary. We believe that it is important that the final rule include the limitations on trader commentary that it clearly disclose that it is written by the trading desk and not a research analyst and what that may mean for the investor. But FINRA is going to categorically eliminate an entire segment of analysis distributed to retail investors without ever showing that this existing practice is in fact harmful or abusive to anyone.

Exemption of Federal Agency Securities. The Revised FINRA Proposal would exclude U.S. Treasury Securities from its scope but would not exclude agency obligations such as obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution. The market in these agency obligations is as transparent as the market for U.S. Treasury Securities. There are no secrets in the market for agency obligations and to subject reports with analysis about that market to the substantial rules governing debt research report is unnecessary and burdensome.

Compensation. Although the Revised FINRA Proposal does state that the debt research department's budget may take into consideration the revenues and results of the firm as a whole, we believe that a similar clarification should be added with respect to the compensation of the debt research analysts. That is, although the firm may not allow compensation based on specific investment banking services or specific trading transactions, we believe that the final rule should clarify that the compensation of a debt research analyst may be based on the revenues or results of the firm as a whole.

Disclosure of Conflicts. The Revised FINRA Proposal does not contain any materiality limitation to the disclosure of conflicts. We believe that the final rule should require disclosure of "all *material* conflicts that reasonably could be expected to influence the objectivity of the debt research report…." To identify literally "all" conflicts that could influence objectivity imposes an unreasonable compliance burden on firms and lacks any usefulness to the investors. Firms should be expected only to identify those conflicts that an investor would consider important in understanding the factors that may influence the analyst. We believe that the materiality limitation would accomplish this.

Definition of Debt Research Report. Although the Revised FINRA Rule specifically excludes from the definition of debt research report the kinds of communications excepted from the definition of "research report" in NASD Rule 2711, it would be helpful to actually put those exceptions into the definition of debt research report to avoid confusion. We have encountered this confusion and we suspect FINRA will too if the exceptions are not clearly stated.

Thank you again for the opportunity to submit these comments.

Sincerely,

Michael Nicholas

Chief Executive Officer

THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH

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April 2, 2012

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

Re: Regulatory Notice 12-09- Debt Research Reports

Dear Ms. Asquith:

This letter is submitted on behalf of the Alliance in Support of Independent Research in response to FINRA's request for comments regarding the above-referenced Regulatory Notice.

Members of the Alliance share a common interest in fostering a favorable regulatory environment in which research services and products may be furnished to the money management community, and in preserving the umbrella of protection Section 28(e) of the Securities Exchange Act of 1934 provides to fiduciaries who receive all forms of investment research.

The leading members of the Alliance in Support of Independent Research include the following broker-dealers:

BNY ConvergEx Group, LLC
John D. Meserve, Executive Managing Director

Capital Institutional Services, Inc.
Kristi P. Wetherington, President and CEO

Knight Capital Group, Inc.
Thomas M. Merritt, Esq., Senior Managing Director and Deputy General Counsel
Kevin M. Donohue, Managing Director
Paul Wagenbach, Esq., Vice President, Assistant General Counsel

The Interstate Group Division of Morgan Keegan & Co., Inc.
Grady G. Thomas, Jr., President
Jay Thomas, Chief Operating Officer

Ms. Marcia E. Asquith
April 2, 2012
Page 2 of 4

Our members are involved in a significant portion of the arrangements under which fiduciaries such as mutual funds, investment advisers, banks and other money managers are provided with independent research services and products for the benefit of their managed accounts.

Application of the Proposal to Independent Third-Party Research

The Alliance's comments are primarily addressed to those aspects of the Regulatory Notice which would impact the provision of third-party debt research by FINRA members to institutional asset managers through client commission arrangements structured to comply with the safe harbor under Section 28(e) of the Securities Exchange Act of 1934. In this regard, we note that in a typical third-party client commission arrangement, at the request of an asset manager, an independent third-party research preparer delivers its research product directly to an asset manager. The "providing" broker-dealer pays the research preparer directly, leaving no opportunity or rationale for the research product to be reviewed by the broker-dealer.[1]

Regulatory Notice 12-09 recognizes that the debt research report rule should generally not apply to independent third-party research, stating:

> The revised proposal also sets out the requirements for the review and distribution of third-party research. It generally incorporates the current standards for third-party equity research, including the distinction between independent and non-independent third-party research with respect to the review and disclosure requirements. In short, a firm need not review independent third-party debt research prior to distribution and may not have to include certain otherwise applicable disclosures depending on whether the research is "distributed" or made available."[2]

Notwithstanding this language from the Regulatory Notice, the actual text of the proposed rule leaves some question as to the responsibilities of broker-dealers who make available independent third-party debt research.[3]

The requirements applicable to the distribution of third-party research reports are contained in paragraph (h)(1) through (h)(5) of the proposed rule. Paragraph (h)(3) of the proposed rule exempts third-party debt research reports from the review requirements of

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[1] See, e.g., SEC Rel. No. 34-54165, 71 Fed. Reg. 41978, 41992 (July 24, 2006). According to the SEC, to satisfy the "provided by" element of Section 28(e), the broker-dealer would either be legally obligated to the research preparer to pay for the research, or would satisfy the element by: 1) paying the research preparer directly; 2) reviewing a description of the services to be paid for for red flags that indicate the services are not within Section 28(e) and agreeing with the Manager to use commissions only to pay for services within the safe harbor; 3) developing procedures so that research payments are documented and paid for promptly. *Id.* at 41994-95.

[2] Regulatory Notice 12-09, at 13.

[3] An independent third-party debt research report is a third-party research report in respect of which the person producing the report: (A) has no affiliation or business or contractual relationship with the distributing member or the member's affiliates reasonably likely to influence the content of the report; and, (B) makes content determinations without any input from the member or a member's affiliates.

(h)(1)(C).[4] Paragraph (h)(4) exempts independent debt research reports "made available" (rather than "distributed to") customers by a broker-dealer from the provisions of paragraph (h)(2)[5] and (h)(1)(B).[6] There does not, however, appear to be any exemption for independent third-party research from the requirements of paragraph (h)(1)(A) or (h)(5) of the proposed rule.

Paragraph (h)(1)(A) requires a broker-dealer who distributes independent third-party research to establish, maintain and enforce policies and procedures reasonably designed to ensure that any third-party debt research report it distributes is "reliable and objective." A broker-dealer who makes available independent debt research reports upon request through a client commission arrangement is not in a position to determine the reliability or objectivity of a report, nor would it necessarily have the capacity to do so, as the research report would typically be selected by the broker-dealer's institutional client and delivered directly to the client by the independent third-party author.

A similar issue is raised by paragraph (h)(5) of the proposed rule, which requires a member to "ensure that a third-party debt research report is clearly labeled as such and that there is no confusion on the part of the recipient as to the person or entity that prepared the debt research report." There are several issues with imposing this obligation on broker-dealers who provide independent third-party research upon request. First, as discussed above, such research is typically selected by, and delivered directly to, a member's institutional client, and is not subject to review by the member. Second, by definition, a member is not in a position to influence or determine the content of independent third-party research, including presumably the labeling of such research as an "independent third-party debt research report."

The Alliance therefore requests that FINRA amend paragraph (h)(4) of the proposed rule to indicate that a member who "makes available" independent debt research will not be considered to have distributed such research for purposes of paragraph (h)(1) and (h)(2) and amend paragraph (h)(3) to extend the exemption contained therein to paragraph (h)(5) in addition to paragraph (h)(1)(C).

Application of the Proposal to Institutional Investors

The Alliance notes that FINRA has proposed that many of the requirements applicable to debt research reports would not apply to reports distributed only to "institutional investors," provided that such institutions have affirmatively notified each broker-dealer in writing that they wish to forego the protection of the rule. This is a change from FINRA's original proposal, which would have automatically excluded institutional

[4] Paragraph (h)(1)(C) requires a member to establish, maintain and enforce procedures designed to ensure that any third-party debt research report it distributes contains no untrue statement of material fact and is otherwise not false or misleading.

[5] Paragraph (h)(2) requires a member to accompany a third-party debt research report with certain disclosures.

[6] This is so because (h)(1)(B) requires a member firm to put in place procedures reasonably designed to ensure that third-party debt research reports contain the disclosures required by (h)(2). Accordingly, a member exempt from making disclosures under (h)(2) would presumably be exempt from drafting procedures to ensure that such disclosures are made.

Ms. Marcia E. Asquith
April 2, 2012
Page 4 of 4

investors from most of the provisions of the rule, unless the institutions "opted-in" to protections available to retail investors. We believe FINRA's original approach, permitting institutions to "opt-in" rather than requiring them to "opt-out" is more appropriate. The default of excluding institutions from most provisions of the debt research report rule is consistent with the general notion under U.S. securities laws and regulations (including FINRA's own suitability rule) that institutions are typically sophisticated investors who are able to independently assess investment opportunities. We also note that the "opt-out" proposal would impose an administrative burden on the back-offices of both member firms and institutions that would likely result in its rare use.

Application of the Proposal to Contacts Between Debt Research Analysts and Trading Staff

Similar to Rule 2711, FINRA's rule governing equity research reports, the debt research report rule would generally restrict contact between debt research analysts and a member's investment banking department. The Alliance supports these provisions. The proposed rule, however, goes far beyond Rule 2711 by additionally restricting many contacts between debt research analysts and a member's sales and trading personnel and principal trading personnel. It is not clear why more onerous regulatory obligations should apply to debt research reports than apply to equity research reports. The disparate application of the debt research report rule and Rule 2711 would impose administrative and compliance burdens on member firms that are not justified by any identified investor protection concerns. Accordingly, the Alliance suggests that if the debt research report proposal is adopted, its coverage be harmonized with Rule 2711.

* * *

The Alliance in Support of Independent Research appreciates the opportunity to comment on these rule changes. If you have any questions, please do not hesitate to contact Lee A. Pickard or William D. Edick at 202-223-4418.

Sincerely,

Lee A. Pickard

Lee A. Pickard
William D. Edick
Pickard and Djinis LLP
Counsel to the Alliance in Support of Independent Research

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March 31, 2012

Ms. Marcia E. Asquith
Office of Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, DC 20006-1506

***Re:* Comments on Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports (FINRA Regulatory Notice 12-09)**

Dear Ms. Asquith:

As a member of the Small Firm Advisory Board (any opinions expressed here are my own and not those of the Board itself) I have had the opportunity to closely monitor the progression of this proposal over the past year. I have witnessed firsthand the rulemaking process and the toil and efforts of FINRA staff to craft a rule that adequately addresses potential conflicts in Debt Research. This rule proposal is much improved from earlier iterations, and I believe that these improvements are largely attributable to FINRAs openness and consideration of comments from a variety of perspectives: member firms, industry groups and associations, and the general public. This is greatly appreciated.

However, I write today with concerns about the rule proposal and specifically its impact on FINRA member Small Firms. I believe that this rule, while well intended, is broad in its scope, at times unnecessarily complex, and as written unduly burdensome on the Small Firm. To this last point, I would argue that it is impossible for many Small Firms to comply with the rule now or at any point in the future, without some type of Small Firm exemption. However, I do think the most current proposal, which gives certain relief to members with Limited Investment Banking Activity provides an excellent starting point.

Before delving into reasons why, let me first comment that I believe the essence and intent of the rule is best captured on page 6 of Regulatory Notice 12-09. It contemplates:

> "... policies and procedures reasonably designed to promote objective and reliable research that reflects the truly held opinions of debt research analysts and prevent the use of debt research reports or debt analysts to manipulate or condition the market in favor of the interest of the firm or current or prospective customers or class of customers."

This is well written and I believe any member firm, large or small, that puts its clients first and makes protection of the public investor a priority will resoundingly agree.

It then continues in the next paragraph:

> "Those policies and procedures must limit the supervision of debt research analysts to persons not engaged in investment banking, sales and trading or principal trading activities. They further require information barriers or other institutional safeguards t o ensure debt analysts are insulated from the review, oversight or pressure from persons engaged in investment banking or principal trading activities or others who might be biased in their judgment or supervision."

This is where the rule becomes problematic, particularly for small firms. Our firm has approximately $1 billion in assets under management and twenty employees, but essentially one person wears the debt analyst/sales and trading hat and is also a member of senior management of the firm. How does one erect an information barrier in such a circumstance? Moreover, how does one construct a practical and effective barrier (and then supervise it) even when these roles are spread out amongst several people in an office of 5,000 square feet? I believe that there are many small boutique firms (perhaps in the hundreds) that are caught in this crossfire. Moreover, I also posit that many firms may not even realize so because they may mistakenly believe that the definition of "debt research" under the rule applies to selling or publishing research , not realizing the broader context of any communiqués they may have with their clients in the process of selling a bond are considered research.

In attempting to limit the interaction between debt research analysts and those outside the research department to preserve independent research, the rule becomes complex, and in my opinion at least, even overreaching. For example, the rule contemplates the determination of research budgets and compensation. While FINRA has given this topic much consideration and has further streamlined the process from prior versions, the rule prohibits certain types of compensation and permits others, calls for the formation of a committee "to annually review and approve of a debt analyst's compensation" taking into account certain named considerations, states who can (by restricting who cannot) be on the committee, AND determines who can and cannot give input in the evaluation process. I am all for truly independent research and preventing undue influence, but from a practical standpoint I've got to believe that this has even Senior Executives and Compliance Officers of Large Firm members scratching their heads. But more to the point of this comment letter, this is again problematic from the perspective of the Small Firms who can't possibly form an independent committee to review the actions of the debt research analysts and sales and trading personnel that would inevitably have to sit on it.

There are many excellent points in the rule. For example, the rule prohibits a research analyst (or a firm through its proprietary trading account) from trading in a manner inconsistent with a debt research analyst's most recently published recommendation. Again, any firm that puts its clients first would unequivocally support this position. At the beginning of the millennium we witnessed rampant abuses where firms shamelessly issued debt research reports and traded (or at the very least commented) the other way, in order to get in good standing with issuers and win subsequent investment banking relationships. If one believes as I do, that this was the very essence behind the genesis of equity research rules and now its debt research counterpart, then I believe that if a firm does no fixed income investment banking business or some *de minimis* amount is a great starting point for a Small Firm carve out of certain aspects of the rule. FINRA's revised proposal "exempts from certain provisions regarding supervision and compensation of debt research analysts those firms that over 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." I wish to comment that this is an excellent starting point for an exemption, and while prior iterations of the rule proposal did not consider such relief (to my knowledge at any rate), it is greatly appreciated that FINRA recognizes potential burdens on Small Firms and is incorporating language into the rule to deal with such hazards. I would add however that because the impact to the Small Firm could be so burdensome, in its attempt to get the exemption right while balancing the integrity and effectiveness of the rule FINRA may wish to perform some type of impact study on small firms just over this exemption metrics implied herein, or at the very least actively identify and encourage further comment from firms on this bubble.

Regulatory Notice 12-09 is not clearly on exactly which provisions Small Firms would actually be exempted, and this must be considered moving forward. I have therefore taken the liberty of sharing a few of my own thoughts. In my opinion, at the very least the carve out should give Small Firms the relief from erecting information barriers or constraints of how compensation is determined and certain other provisions that are simply not practical from a Small Firm standpoint (and from a FINRA perspective probably difficult to enforce as such). However, I would also envision that it would not exempt Small Firms from what I call the "core" provisions of the rule (proprietary and personal trading provisions for example which are ethical standards that can be maintained regardless of firm size). Because Small Firms would not be exempted from these provisions, the public would still be protected even with this carve out. Moreover, I would argue that an additional safety net already is in place for the public, as there are already ample rules on the books (Rules of Fair Dealing, etc.) that could be enforced as a fallback position.

Thank you for the opportunity to comment on Regulatory Notice to Members 12-09.

Sincerely,

Joseph R.V. Romano
President
FINRA Small Firm Advisory Board Member

Additional Points of Comment:

1. The rule often references principal and proprietary trading, but I believe a distinction can and should be made for members at large. As an industry wide practice, many firms (in my estimation the majority of firms) run customer fixed income transactions essentially contemporaneously through their principal trading account with a reasonable markup. I think

this customary practice should be distinguished from proprietary trading where a firm seeks to profit from a change in market value of an underlying security. This latter practice is more subject to potential abuse because without disclosure clients would not know if a firm holds a position and therefore if it in so doing it conflicts with published debt research issued from the firm. On the other hand, this is not as much an issue on trades almost contemporaneously run through the principal side as firms will have a hard time selling fixed income positions run through their principal trading account to clients if they are issuing research, presumably to those same clients, which state a contra position.

2. **As a further footnote, while municipal securities are not addressed in the scope and definitions in this rule presumably because they are covered by the MSRB, it is likely that the MSRB will mirror this rule on its books. Therefore, it is imperative to Small Firms that the rule gets written correctly the first time. Also, I believe anecdotally at least, that if municipal securities fall under the rule via an MSRB interpretation, the number of Small Firms affected mushrooms, as Small Firms are less likely to actively to underwrite corporate securities (a Large Firm market), but are often very active in municipal underwriting particular in the local and State arenas. This is problematic and bears great consideration.**

FINRA

Regulatory Notice 12-42

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

Comment Period Expired: December 20, 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.

Due to the disruption of normal business operations relating to Hurricane Sandy, FINRA is extending the deadline to provide comment to December 20, 2012. Original deadline: December 10, 2012.

View Full Notice PDF *158 KB*

The views, expressions, findings and opinions expressed in the comments on this Web page are solely those of the author(s) and FINRA accepts no responsibility for the content of the comments.

Comments By	Date Received
CFA Institute (PDF *138 KB*)	12/7/2012
The Alliance in Support of Independent Research (PDF *327 KB*)	12/20/2012
Bond Dealers of America (PDF *318 KB*)	12/21/2012
BMO Capital Markets (PDF *842 KB*)	12/21/2012
SIFMA (PDF *887 KB*)	1/4/2013

BDA Bond Dealers of America

21 Dupont Circle, NW • Suite 750
Washington, DC 20036
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December 20, 2012

VIA ELECTRONIC MAIL

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K. Street, NW
Washington, DC 20006-1506

RE: Regulatory Notice 12-42: FINRA Requests Comment on a Revised Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports

Dear Ms. Asquith:

On behalf of its members, the Bond Dealers of America (BDA) is pleased to submit this letter in response to the Financial Industry Regulatory Authority's (FINRA) solicitation of comments in connection with its Regulatory Notice 12-42 in which it revised its debt research report proposal (Revised Proposal). BDA is the only DC based group representing the interests of securities dealers and banks focused on the U.S. fixed income markets. The Revised Proposal will directly impact many of our members. Accordingly, we welcome this opportunity to state our position.

While we are encouraged that the Revised Proposal incorporates several of our comments, we reiterate several of the concerns we raised in our comment letter to the original proposal.

Definition of Debt Research Report. We believe that subsection (a)(3)(C) of the proposed rule should be revised to exclude offering documents for unregistered transactions and securities. If a document is prepared by or at the request of the issuer or obligor of a security, such document should be specifically excluded from the definition of Debt Research Report under the proposed rule.

Institutional Investor Exception. While the Revised Proposal changes how institutional investors are excluded from the debt research report rules, it continues to impose a considerable burden on dealers and so it does not address our underlying concern. We believe that the debt research report rules should categorically exclude qualified institutional buyers from their scope. Qualified institutional buyers are in the business of investing and dealers should have no requirement other than ensuring that the institutional investor is in fact a qualified institutional buyer. Accordingly, we believe that FINRA should eliminate the requirements in (j)(1)(A) borrowed from FINRA Rule 2111 such as the requirement that, to be excluded, qualified institutional buyers must affirmatively indicate that they are exercising independent judgment in evaluating the dealer's recommendations. In addition, we find it strange that a dealer may recommend a fixed income security to an "institutional account" if it follows the suitability requirements of FINRA Rule 2111 but those do not suffice for sending a debt research report to an "investment account" that is not a qualified institutional buyer. Therefore, we believe that the debt research rule should categorically exclude qualified institutional buyers and then impose requirements for other "institutional accounts" similar to the suitability standards for "institutional accounts" under Rule 2111.

Trading and Sales Reports. As outlined in The Bond Market Association's *Guiding Principles to Promote Integrity of Fixed Income Research* (Guiding Principles), we believe that trading and sales reports should be excluded from the revised proposal as it relates to institutional investors. Trader commentary is typically specific to bonds and how they are priced. Trader commentary forms an intrinsic part of how bonds are sold and its inclusion in the debt research rules is misplaced. We do not believe that institutional investors would be confused by trader commentary or believe that it represents the work product of an independent debt research analyst. We believe that the exclusion of trading and sales reports under the Guiding Principles was appropriate as long as there was accompanying language clearly disclosing that it is trader commentary.

Exemption of Federal Agency Securities. We reiterate our concern that agency obligations should be excluded from the debt research report rules just like U.S. Treasuries are excluded. Agency obligations, such as obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution, are generally treated as U.S. Treasuries with respect to their characteristics and qualities. Further, the offer and sale of agency obligations is exempt from registration under the securities laws which evidences Congress's belief that investors in agency obligations do not have the same need of the securities laws as with non-exempt securities and we believe that same reasoning extends to research reports about agency obligations as well. As a result, the market in these agency obligations is as transparent as the market for U.S. Treasury Securities. Further, it is unlikely that dealers would have conflicts of interests with respect to agency obligations that are much different than they would with U.S. Treasuries. Accordingly, we believe that agency obligations should be excluded from the coverage of the debt research report rule.

Compensation. Although the Revised Proposal does state that the debt research department's budget may take into consideration the revenues and results of the firm as a whole, we believe that a similar clarification should be added with respect to the compensation of the debt research analysts. That is, although the firm may not allow compensation based on specific investment banking services or specific trading transactions, we believe that the final rule should clarify that the compensation of a debt research analyst may be based on the revenues or results of the firm as a whole.

Thank you again for the opportunity to submit these comments.

Sincerely,

Michael Nicholas

Chief Executive Officer

THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH

C/O PICKARD AND DJINIS LLP
ATTORNEYS AT LAW
1990 M STREET, N.W.
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(202) 223-4418

TELECOPIER
(202) 331-3813

December 20, 2012

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

Re: Regulatory Notice 12-42- Debt Research

Dear Ms. Asquith:

This letter is submitted on behalf of the Alliance in Support of Independent Research in response to FINRA's request for comments regarding the above-referenced Regulatory Notice.

Members of the Alliance share a common interest in fostering a favorable regulatory environment in which research services and products may be furnished to the money management community, and in preserving the umbrella of protection Section 28(e) of the Securities Exchange Act of 1934 provides to fiduciaries who receive all forms of investment research.

The leading members of the Alliance in Support of Independent Research include the following broker-dealers:

Capital Institutional Services, Inc.
Kristi P. Wetherington, President and CEO

ConvergEx Group, LLC
John D. Meserve, Executive Managing Director

Knight Capital Group, Inc.
Thomas M. Merritt, Esq., Senior Managing Director and Deputy General Counsel
Kevin M. Donohue, Managing Director
Paul Wagenbach, Esq., Vice President, Assistant General Counsel

The Interstate Group Division of Morgan Keegan & Co., Inc.
Grady G. Thomas, Jr., President
Jay Thomas, Chief Operating Officer

Ms. Marcia E. Asquith
December 20, 2012
Page 2 of 2

Our members are involved in a significant portion of the arrangements under which fiduciaries such as mutual funds, investment advisers, banks and other money managers are provided with independent research services and products for the benefit of their managed accounts.

Application of the Proposal to Independent Third-Party Research

The Alliance filed a comment letter on April 2, 2012 primarily addressing the application of FINRA's prior debt research proposal (Regulatory Notice 12-09) to independent third party research.[1] As set forth in detail in the April 2, 2012 letter, the Alliance was concerned that the proposal could be read to impose obligations on FINRA members who make available independent third party debt research to establish, maintain and enforce procedures to ensure that such reports are reliable and objective and/or to ensure that such reports are labeled in a particular manner. Independent third party research distributed by a member pursuant to Section 28(e) of the Securities Exchange Act of 1934 is typically selected by the member's institutional client, and delivered directly to the institutional client by an unaffiliated research vendor, and as such it is not subject to review by the member. Furthermore, by definition, a member is not in a position to influence or determine the content of independent third party research.

The issues raised in our April 2, 2012 letter do not appear to have been addressed in Regulatory Notice 12-42. Accordingly, the Alliance respectfully requests that FINRA clarify that the provisions set forth above do not apply to members who make available independent third party debt research under Section 28(e).

* * *

The Alliance in Support of Independent Research appreciates the opportunity to comment on these rule changes. If you have any questions, please do not hesitate to contact Lee A. Pickard or William D. Edick at 202-223-4418.

Sincerely,
Lee A Pickard
Lee A. Pickard
William D. Edick
Pickard and Djinis LLP
Counsel to the Alliance in Support of Independent Research

Enc.

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[1] The Alliance's April 2, 2012 letter is attached hereto and incorporated by reference to the extent the issues raised in the letter have not been addressed by Regulatory Notice 12-42.

THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH

C/O PICKARD AND DJINIS LLP
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April 2, 2012

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

Re: Regulatory Notice 12-09- Debt Research Reports

Dear Ms. Asquith:

This letter is submitted on behalf of the Alliance in Support of Independent Research in response to FINRA's request for comments regarding the above-referenced Regulatory Notice.

Members of the Alliance share a common interest in fostering a favorable regulatory environment in which research services and products may be furnished to the money management community, and in preserving the umbrella of protection Section 28(e) of the Securities Exchange Act of 1934 provides to fiduciaries who receive all forms of investment research.

The leading members of the Alliance in Support of Independent Research include the following broker-dealers:

BNY ConvergEx Group, LLC
John D. Meserve, Executive Managing Director

Capital Institutional Services, Inc.
Kristi P. Wetherington, President and CEO

Knight Capital Group, Inc.
Thomas M. Merritt, Esq., Senior Managing Director and Deputy General Counsel
Kevin M. Donohue, Managing Director
Paul Wagenbach, Esq., Vice President, Assistant General Counsel

The Interstate Group Division of Morgan Keegan & Co., Inc.
Grady G. Thomas, Jr., President
Jay Thomas, Chief Operating Officer

Ms. Marcia E. Asquith
April 2, 2012
Page 2 of 4

Our members are involved in a significant portion of the arrangements under which fiduciaries such as mutual funds, investment advisers, banks and other money managers are provided with independent research services and products for the benefit of their managed accounts.

Application of the Proposal to Independent Third-Party Research

The Alliance's comments are primarily addressed to those aspects of the Regulatory Notice which would impact the provision of third-party debt research by FINRA members to institutional asset managers through client commission arrangements structured to comply with the safe harbor under Section 28(e) of the Securities Exchange Act of 1934. In this regard, we note that in a typical third-party client commission arrangement, at the request of an asset manager, an independent third-party research preparer delivers its research product directly to an asset manager. The "providing" broker-dealer pays the research preparer directly, leaving no opportunity or rationale for the research product to be reviewed by the broker-dealer.[1]

Regulatory Notice 12-09 recognizes that the debt research report rule should generally not apply to independent third-party research, stating:

> The revised proposal also sets out the requirements for the review and distribution of third-party research. It generally incorporates the current standards for third-party equity research, including the distinction between independent and non-independent third-party research with respect to the review and disclosure requirements. In short, a firm need not review independent third-party debt research prior to distribution and may not have to include certain otherwise applicable disclosures depending on whether the research is "distributed" or made available."[2]

Notwithstanding this language from the Regulatory Notice, the actual text of the proposed rule leaves some question as to the responsibilities of broker-dealers who make available independent third-party debt research.[3]

The requirements applicable to the distribution of third-party research reports are contained in paragraph (h)(1) through (h)(5) of the proposed rule. Paragraph (h)(3) of the proposed rule exempts third-party debt research reports from the review requirements of

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[1] See, e.g., SEC Rel. No. 34-54165, 71 Fed. Reg. 41978, 41992 (July 24, 2006). According to the SEC, to satisfy the "provided by" element of Section 28(e), the broker-dealer would either be legally obligated to the research preparer to pay for the research, or would satisfy the element by: 1) paying the research preparer directly; 2) reviewing a description of the services to be paid for for red flags that indicate the services are not within Section 28(e) and agreeing with the Manager to use commissions only to pay for services within the safe harbor; 3) developing procedures so that research payments are documented and paid for promptly. *Id.* at 41994-95.

[2] Regulatory Notice 12-09, at 13.

[3] An independent third-party debt research report is a third-party research report in respect of which the person producing the report: (A) has no affiliation or business or contractual relationship with the distributing member or the member's affiliates reasonably likely to influence the content of the report; and, (B) makes content determinations without any input from the member or a member's affiliates.

Ms. Marcia E. Asquith
April 2, 2012
Page 3 of 4

(h)(1)(C).[4] Paragraph (h)(4) exempts independent debt research reports "made available" (rather than "distributed to") customers by a broker-dealer from the provisions of paragraph (h)(2)[5] and (h)(1)(B).[6] There does not, however, appear to be any exemption for independent third-party research from the requirements of paragraph (h)(1)(A) or (h)(5) of the proposed rule.

Paragraph (h)(1)(A) requires a broker-dealer who distributes independent third-party research to establish, maintain and enforce policies and procedures reasonably designed to ensure that any third-party debt research report it distributes is "reliable and objective." A broker-dealer who makes available independent debt research reports upon request through a client commission arrangement is not in a position to determine the reliability or objectivity of a report, nor would it necessarily have the capacity to do so, as the research report would typically be selected by the broker-dealer's institutional client and delivered directly to the client by the independent third-party author.

A similar issue is raised by paragraph (h)(5) of the proposed rule, which requires a member to "ensure that a third-party debt research report is clearly labeled as such and that there is no confusion on the part of the recipient as to the person or entity that prepared the debt research report." There are several issues with imposing this obligation on broker-dealers who provide independent third-party research upon request. First, as discussed above, such research is typically selected by, and delivered directly to, a member's institutional client, and is not subject to review by the member. Second, by definition, a member is not in a position to influence or determine the content of independent third-party research, including presumably the labeling of such research as an "independent third-party debt research report."

The Alliance therefore requests that FINRA amend paragraph (h)(4) of the proposed rule to indicate that a member who "makes available" independent debt research will not be considered to have distributed such research for purposes of paragraph (h)(1) and (h)(2) and amend paragraph (h)(3) to extend the exemption contained therein to paragraph (h)(5) in addition to paragraph (h)(1)(C).

Application of the Proposal to Institutional Investors

The Alliance notes that FINRA has proposed that many of the requirements applicable to debt research reports would not apply to reports distributed only to "institutional investors," provided that such institutions have affirmatively notified each broker-dealer in writing that they wish to forego the protection of the rule. This is a change from FINRA's original proposal, which would have automatically excluded institutional

[4] Paragraph (h)(1)(C) requires a member to establish, maintain and enforce procedures designed to ensure that any third-party debt research report it distributes contains no untrue statement of material fact and is otherwise not false or misleading.

[5] Paragraph (h)(2) requires a member to accompany a third-party debt research report with certain disclosures.

[6] This is so because (h)(1)(B) requires a member firm to put in place procedures reasonably designed to ensure that third-party debt research reports contain the disclosures required by (h)(2). Accordingly, a member exempt from making disclosures under (h)(2) would presumably be exempt from drafting procedures to ensure that such disclosures are made.

investors from most of the provisions of the rule, unless the institutions "opted-in" to protections available to retail investors. We believe FINRA's original approach, permitting institutions to "opt-in" rather than requiring them to "opt-out" is more appropriate. The default of excluding institutions from most provisions of the debt research report rule is consistent with the general notion under U.S. securities laws and regulations (including FINRA's own suitability rule) that institutions are typically sophisticated investors who are able to independently assess investment opportunities. We also note that the "opt-out" proposal would impose an administrative burden on the back-offices of both member firms and institutions that would likely result in its rare use.

Application of the Proposal to Contacts Between Debt Research Analysts and Trading Staff

Similar to Rule 2711, FINRA's rule governing equity research reports, the debt research report rule would generally restrict contact between debt research analysts and a member's investment banking department. The Alliance supports these provisions. The proposed rule, however, goes far beyond Rule 2711 by additionally restricting many contacts between debt research analysts and a member's sales and trading personnel and principal trading personnel. It is not clear why more onerous regulatory obligations should apply to debt research reports than apply to equity research reports. The disparate application of the debt research report rule and Rule 2711 would impose administrative and compliance burdens on member firms that are not justified by any identified investor protection concerns. Accordingly, the Alliance suggests that if the debt research report proposal is adopted, its coverage be harmonized with Rule 2711.

* * *

The Alliance in Support of Independent Research appreciates the opportunity to comment on these rule changes. If you have any questions, please do not hesitate to contact Lee A. Pickard or William D. Edick at 202-223-4418.

Sincerely,

Lee A. Pickard

Lee A. Pickard
William D. Edick
Pickard and Djinis LLP
Counsel to the Alliance in Support of Independent Research

CFA Institute

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7 December 2012

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

Re: Comments on FINRA's Revised Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports (FINRA Regulatory Notice 12-42)

Dear Ms. Asquith:

CFA Institute[1] appreciates the opportunity to provide comments on FINRA's revised proposal relating to potential conflicts of interest in the preparation and distribution of debt research reports. CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Executive Summary

CFA Institute supports efforts aimed at preventing conflicts of interest relating to the work of research analysts and the investment banking and trading sides of a firm. Untainted research must be safeguarded from undue influence that otherwise erodes market integrity and investors' trust in the system.

Exemption for "Higher-Tier" Institutional Investors

We support the proposal that would allow qualified institutional buyers that meet certain requirements to receive debt research that does not contain the disclosures required for research reports provided to retail investors. This group of institutional investors should possess the knowledge and expertise that allow them to independently evaluate the research they receive.

[1] CFA Institute is a global, not-for-profit professional association of more than 111,800 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of more than 104,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 countries and territories.

CFA Institute

Exemption for Firms with Limited Principal Debt Trading

While we are not opposed to providing exemptions in cases where the costs of compliance clearly outweigh certain risks, we are not convinced that firms with limited debt trading activities would suffer a hardship absent the proposed exemption. We would welcome additional research by FINRA on this point.

Limited Investment Banking Exemption

We generally support the proposed exemption for firms with limited investment banking activities in part because this exemption harmonizes with that currently provided in FINRA rules for equity security research.

Discussion

As a membership organization of Chartered Financial Analysts, we are keenly aware of, and strongly support efforts to manage conflicts of interest relating to the preparation and issuance of research reports. Investors deserve to receive research reports that are not compromised by other interests or influence exerted by the investment banking or trading sides of an organization. Moreover, analysts themselves should not be unduly pressured by other arms of an organization to tailor research reports or to otherwise have their compensation linked to activities outside those related to research. As importantly, the marketplace must be able to trust the impartiality of the analysts and the integrity of the report in order to invest with confidence.

We generally support the proposed requirements aimed at identifying and managing the conflicts of interest that may arise between the research arm of a company and its investment banking business. This revised proposal, drawing close parallels to rules governing equity research, goes to the heart of the issues involved in pressures that threaten to undermine the independence and objectivity of analyst research.

We strongly support FINRA's initiatives to strengthen the ability of research analysts to provide unbiased and sound research reports and recommendations without undue influence from their employers or the companies they cover in the equity securities market. We appreciate FINRA's creation of the current rules that govern research for equity securities. We now support efforts through this proposal to extend these safeguards to debt research analysts.

Institutional Investor Exemption

A prior proposal issued by FINRA required institutional investors to affirmatively "opt-in" by requiring them to provide written notice that they wished to receive debt research reports without the accompanying disclosures and other protections afforded retail investors. This revised proposal recognizes that this opt-in requirement not only is tedious but also unnecessary in some circumstances.

Specifically, in order to address this issue, this proposal creates a "higher tier" of institutional investors that would be allowed to receive the research reports by way of "negative consent," meaning that the investor simply does not indicate to the firm that it wants to be treated as a

CFA Institute

retail investor. In order to claim this exemption, an investor in this tier must qualify as a "qualified institutional buyer" (QIB) as defined under Rule 144A and satisfy new institutional suitability standards under FINRA Rule 2111 requiring that (a) the research provider has a reasonable basis to believe the investor is capable of evaluating the risks independently, and (b) the investor confirms it is exercising independent judgment in evaluating the firm's recommendations.

We support this approach. A QIB that qualifies under Rule 144A presumably has the capability and sophistication to evaluate the research involving debt securities without the disclosures and other protections that accompany reports provided retail investors. We also support retaining a requirement that institutional investors that do not fall within the higher tier category still be allowed to receive the research without the retail investor protections but only if they notify the provider firm in writing of this election.

Limited Principal Debt Trading Exemption

Unlike FINRA's earlier proposal, this proposal would provide an exemption for firms with limited principal debt trading activity from the requirement to separate research analysts from those engaged in sales and trading and principal trading activities with respect to (a) pre-publication review of debt research, (b) supervision and compensation of the research analysts, and (c) research budget determinations. FINRA notes that in proposing this exemption, it considered the ability of smaller firms and its limited personnel to effectively create the separations between research and trading activities, as well as a trading revenue threshold that most likely minimizes the types of conflicts that arise between these two arms. In order to qualify for the exemption, a firm must (1) have gains or losses (in absolute value) of less than $15 million derived from principal debt trading on average over the previous three years; and (2) have fewer than 10 debt traders.

In offering this exemption, FINRA conducted research on smaller firms' activities, including breakdowns on categories of debt trading, whether their traders wrote research and the firms' ability to structurally separate debt research analysts from others. FINRA's research also indicated that firms with fewer than 10 debt traders typically do not dedicate a trader to writing research.

What is not clear from FINRA's description of its research is whether separation requirements would impose a hardship on the firm that would substantially outweigh separation requirements. Without clear evidence that separation impairs the ability of a large number of firms of this size to create quality debt research, we cannot support such an exemption. The evidence with regard to the negative effects of conflicted interests, on the other hand, is significant and clear. Without separation, such research is subject to influences that could compromise the independence and accuracy of the analysis and opinions provided. Moreover, the potential for traders to act on the research prior to its publication and distribution is an unacceptable outcome, regardless of the size of a firm's trading desk.

CFA Institute

We suggest, therefore, that FINRA closely review the records it is requiring of firms that claim the exemption to keep for three years with respect to communications that otherwise would be subject to pre-publication review. Close review of these records may determine whether this exemption is warranted or subject to abuse.

Limited Investment Banking Exemption

This proposal tracks existing FINRA equity security research rules by maintaining an exemption for firms that have limited investment banking activity. Under the exemption, firms would not be required to separate research analysts from investment banking personnel with respect to (a) pre-publications review of the research, (b) supervision and compensation of research analysts, and (c) research budget determinations. Firms qualifying for the exemption would, during the previous three years (on average per year), have participated in 10 or fewer investment banking transactions acting as manager or co-manager and generated $5 million or less in gross investment banking revenues from the transactions.

For the same reasons noted above, we cannot support removing the separation between investment banking and research due to the potential conflicts of interest involved.

Conclusion

We appreciate FINRA's efforts to establish regulations for debt security research that are substantially consistent with those implemented for equity security research. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Linda L. Rittenhouse at linda.rittenhouse@cfainstitute.org or 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director, Standards and
Financial Market Integrity
CFA Institute

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
Director, Capital Markets Policy
CFA Institute

BMO Capital Markets

BMO Capital Markets GKST Inc.
115 South LaSalle Street
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Tel.: 312 845-2000

December 20, 2012

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

Re: Regulatory Notice 12-42—Debt Research ("Notice")

Dear Ms. Asquith:

This comment letter on the rule proposal ("Proposal") in the Notice is submitted by BMO Capital Markets GKST Inc. ("BMOGKST"), a registered broker-dealer with the SEC and the MSRB. BMOGKST was founded in 1980 as Griffin, Kubik, Stephens & Thompson, Inc. It initially specialized in the underwriting and distribution of tax-exempt municipal bonds, almost exclusively to institutional customers, most of which were small and mid-size banks. As it grew, it became involved with other types of fixed-income securities such as governments and agencies. BMOGKST has approximately 120 employees, most of whom are engaged in sales and trading activities. It has a public finance group as well as relatively small credit analytics and strategic analytics groups. It is the activities of the latter group which have prompted the writing of this comment letter.

In 2008, BMOGKST was acquired by BMO Financial Group, and it continues post-acquisition to cater to institutional customers, a large percentage of which are still small and mid-size banks and what are known as Tier II and Tier III institutions. BMOGKST believes that it has a major niche in the coverage of that market. As will be described below, the ability to distribute trader commentary to those clients is of utmost importance to BMOGKST, its clients and the functioning of the debt markets in general.

While we support fully the objectives of the Proposal, we believe that even after FINRA's revision of the Proposal, it continues to impose undue burdens and obstacles upon the ability of smaller firms such as BMOGKST to provide trader commentary to Institutional Investors which are not Qualified Institutional Buyers, as we explain below.

The BMOGKST strategic analytics group exists for one purpose only—to support the Firm's sales activities to its institutional customers. The group produces trader commentary on a weekly, monthly and periodic basis, the objective of which is to relay to institutional clients the direction of the fixed-income markets and the relative value of various highly-rated, deeply liquid categories of fixed-income investments, such as municipals, treasuries, agencies, mortgage-backeds and other asset-backed securities. The group performs no fundamental research of any kind and does not comment on nor otherwise participate in anything related to the corporate bond market. Given the size and scope of BMOGKST's business generally and that of the strategic analytics group in particular, the types of segregated management provisions proposed for debt research by the Proposal would be a tremendous burden and would place BMOGKST at a competitive disadvantage in providing trader commentary as a service to small and mid-size institutions. We believe that there is no need for new regulation of "trader commentary", but any regulation of trader commentary should be the subject of a more in depth assessment of the costs and benefits than is evident in the Notice or the Proposal.

Two of our specific concerns are that:

1. Institutional distribution of trader commentary should be exempt, subject to the ability to opt out of the exemption.
2. Any restriction of the participation of persons engaged in sales and trading or principal trading activities in the management of research personnel should clarify the distinction between sales and trading in general and those truly engaged in proprietary trading activities.

We elaborate on our thoughts below.

First, the proposed definition of "debt research report" should not include the type of activity engaged in by the strategic analytics group of BMOGKST because there is no potential for manipulating the debt markets by publishing commentary on what is happening in those markets based on a relative value analysis of the most liquid, credit-risk-free instruments in all of the securities markets. Price movements in debt securities are limited by par value, maturity and interest rate parameters. Unlike equity markets, there are top and bottom limits that cannot be exceeded (except in the case of major credit issues, which are not a factor in the types of securities that we are dealing with). The markets, and the types of securities involved, are too deep and too liquid to be moved by any one firm's commentary as to the relative value of highly rated debt issuers which do not have credit issues.

Second, we believe that the Proposal should be limited to fundamental research, as opposed to trader commentary relating to interest-rate movements demonstrated by market forces for highly-rated and extremely liquid securities. We would be pleased to provide to FINRA amendments to the Proposal which would clarify this distinction.

We note that FINRA has stated that it will undertake cost-benefit analyses of its rules. The impact of the Proposal on trader commentary deserves further rigorous cost-benefit analysis, because we apprehend that the restructuring, inefficiencies and compliance costs to members would overshadow any benefits to the public. Trader commentary is already subject to extensive rules, regulations and safeguards, including reviews by supervisors, legal and compliance personnel and ultimately by regulators in their periodic examinations. This present mechanism is a more cost-effective manner to protect the public than the forced management restructuring and the ongoing compliance costs that would be associated with such a requirement.

We do support the Proposal's exemption for institutional recipients. We believe, however, that a less cumbersome procedure is necessary to preserve and protect the interests of the smaller and mid-size institutional clients. An affirmative consent provision is cumbersome and burdensome. We cover thousands of such clients. In most cases they have been receiving this type of commentary for years. They will be adequately protected by having the ability to notify us that they did not want to receive our commentary. In that regard, our experience with obtaining Rule 2111 institutional suitability certificates is that clients sometimes do not return the paperwork (in particular duplicate paperwork as they do not understand the need, for example, to produce different certificates for different situations, such as QIB qualification, compliance with Rule 2111 and, if this proposal is adopted, institutional consent to receive trader commentary) especially when they have been doing business with us for so many years.

We also would like to make one particular point with respect to the supposed distinction between "principal trading activities" and "sales and trading" in section (b) (3) (A) (ii) and (iii) of the Proposal in the context of a restriction on compensation decisions. Firms, such as ours, which participate in the underwriting and distribution of fixed-income securities, do so entirely on a principal basis. All of such activity is in the form of inventory management in order to sell such securities to customers. We do not trade for our own account and therefore do not have principal trading activities, but our trading personnel do position securities in the course of selling them to customers. We urge FINRA to clarify that such personnel are not deemed to be engaged in "principal trading activities".

Thank you for the opportunity to comment. If it would be helpful, we would be pleased to supply you with the type of commentary we have supplied to institutional clients for many years.

Very truly yours,

Robert J. Stracks
Counsel

RJS/ays

sifma
Invested in America

January 4, 2013

Exclusively via e-mail to pubcom@finra.org

Ms. Marcia E. Asquith
Office of Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

Re: Comments on FINRA's Proposed Rule Regarding Conflicts Involving the Preparation & Distribution of Debt Research Reports (FINRA Regulatory Notice 12-42)

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("SIFMA")[1] submits this letter to the Financial Industry Regulatory Authority, Inc. ("FINRA") in response to FINRA's request for comments regarding its proposal to promulgate wide-ranging rules applicable to the publication and distribution of debt research reports (the "Proposed Rule").[2] SIFMA welcomes the opportunity to respond to FINRA's Proposed Rule.

I. INTRODUCTION

SIFMA appreciates FINRA's extensive efforts to obtain input from firms regarding debt research and the role that debt research analysts play in the fixed income markets. Many of the revisions included in Regulatory Notice 12-42 (and the accompanying rule text) respond to prior industry comments and appear to be carefully tailored to take into consideration the key differences between the debt and equity markets and the unique nature of debt research. In particular, we sincerely appreciate FINRA's willingness to amend its rule to be consistent with the definitions in SEC Regulation AC[3] and its recognition that certain institutions are sophisticated and capable of making investment decisions based on research provided by broker-dealers. FINRA's changes to its original

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] *See generally* FINRA Regulatory Notice 12-42 and the accompanying proposed rule text.

[3] SIFMA notes that there continue to be several small grammatical variations between Regulation AC and its exclusions and the FINRA Proposed Rule. We understand that these are not designed to result in interpretive differences, but request that FINRA revise its Proposed Rule so that there is no misunderstanding in the future. If the grammatical variations are intentional, we request further clarification.

proposal will significantly reduce unnecessary costs and confusion among broker-dealers and their clients.

SIFMA, however, continues to have concerns about certain aspects of the Proposed Rule. In particular, we believe that the following few areas should be modified:

- Institutional Debt Research Exemption: SIFMA believes the proposed "higher tier" definition of institutional investor – *i.e.,* qualified institutional investor ("QIB") plus satisfaction of the FINRA Rule 2111 institutional suitability standard – would introduce a confusing new standard for clients and be costly to implement. It also could potentially disadvantage institutional clients who have represented that they are capable of, and are in fact, making independent investment decisions, and should therefore be capable of analyzing "institutional debt research" even though they do not satisfy the proposed two-part definition.

- Separation of Principal Trading from Research Department: SIFMA is concerned that without a precise definition of "principal trading," the term could be read to encompass virtually all fixed income trading operations, given that the fixed income market operates primarily on a principal trading basis. If the term is meant to be read this broadly, the prohibitions in the Proposed Rule on considering revenue derived from, and input from personnel involved in, a firm's principal trading operations when making research department budgetary, evaluation and compensation decisions would likely create an imbalance between research resources and the needs of clients. This separation would largely eliminate effective client feedback on the performance of a firm's research department and research analysts.

- Additional Comments – Road Show Prohibition: Based on equity research standards, FINRA proposes to prohibit debt research analyst participation in road shows related to an investment banking services transaction. Importing this provision to debt research does not take into consideration key differences between equity and debt operations and potential unintended negative effects.

We believe the proposed modifications discussed in this comment letter are critical to preserve undisrupted access by clients to debt research and to allow research management to make well-informed decisions regarding firms' and clients' research needs. We also believe the Proposed Rule, as currently structured, will impose undue costs and burdens on the industry. Given the many other safeguards already built into the Proposed Rule, we believe the changes discussed in this comment letter will more appropriately balance the important goals of investor protection and integrity of research with the costs and burdens of the rule.

II. PROPOSED INSTITUTIONAL EXEMPTION

A. Summary of the FINRA Proposal

FINRA is proposing a higher tier of institutional investors that would be able to receive "institutional debt research" if a firm meets certain conditions under the Proposed Rule.[4] The higher tier exemption would be available to an institutional investor that (i) meets the definition of QIB and (ii) satisfies the new FINRA Rule 2111 institutional suitability standards that require that (a) a 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 Rule; and (b) the institutional investor has affirmatively indicated that it is exercising independent judgment in evaluating the firm's recommendations pursuant to the suitability rule, provided such affirmation generally covers transactions in debt securities ("Proposed Exemption").

B. Concerns with the Proposed Exemption

SIFMA appreciates FINRA's recognition that a category of institutions is sophisticated and capable of both assessing its own investment needs and making investment decisions based on research provided by broker-dealers. We are also grateful for FINRA's willingness to address the industry's concern that the recent proliferation of regulatory requirements to obtain client representations (*e.g.*, FINRA Rule 2111, the Dodd-Frank Act) has created compliance and systems challenges and placed significant constraints on firm resources. Coming close in time, but in an uncoordinated fashion, these various requirements also have the potential to confuse clients.

Although basing the Proposed Exemption on two existing certifications may appear at first glance to address these concerns, in fact it raises more problems than it solves. As discussed below, we believe the Proposed Exemption is impractical in many respects, creates a confusing new standard for clients, and potentially disadvantages institutional clients who have represented that they are capable of, and are in fact, making independent investment decisions, and who should therefore be capable of analyzing institutional debt research even though they do not satisfy the proposed two-part definition.

i. Incompatible Standards

As you are aware, FINRA member firms have recently implemented processes to satisfy the institutional suitability requirements under FINRA Rule 2111, which included obtaining from institutional clients an affirmative indication (for these purposes referred to as "Suitability Certifications") that the client is exercising independent judgment in evaluating recommendations. These Suitability Certifications are obtained from clients and tracked in firm systems at the relationship, or order placer, level. In contrast, QIB Certificates designed to address SEC Rule 144A are tracked for specific transactions, largely at the underlying account level. This reflects the different purposes of FINRA Rule 2111 and SEC Rule 144A – FINRA Rule 2111 was primarily designed to clarify client relationships with broker-dealers, while SEC Rule 144A was primarily designed to address eligibility for particular transactions.

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[4] *See* FINRA Regulatory Notice 12-42 at p.3.

Joining these two disparate standards would create anomalous results. For example, registered investment advisers who have completed a Suitability Certification may have multiple large underlying accounts – half of which have participated in a SEC Rule 144A transaction and thus have signed a QIB Certificate, and half of which have not. Under the Proposed Exemption, the registered investment adviser would be able to use institutional debt research for half of its accounts under management, but not the other half. Not only would this result in the inequitable treatment of similarly situated accounts, it would be extremely difficult to monitor or enforce, particularly because the registered investment adviser has a duty to use pertinent information to the benefit of all its advised accounts. The Proposed Exemption could also result in a situation where a client of a firm that has signed a QIB Certificate (representing that it is sophisticated and well capitalized) transacts in restricted securities with the firm, while unable to receive research on any debt instrument, including restricted securities, without taking additional steps.

In addition, under the Proposed Exemption, registered broker-dealers could potentially be precluded from obtaining institutional debt research. Specifically, because registered broker-dealers are not "customers," they do not make an affirmative acknowledgment under FINRA Rule 2111. In addition, under SEC Rule 144A,[5] unless acting in a riskless principal basis, only certain broker-dealers qualify as QIBs.[6] Because firms are unable to identify the specific size of broker-dealer counterparties at the relationship level (as opposed to individual transactions), this standard effectively could deny these broker-dealer counterparties access to institutional research – a result that would serve no investor protection goals.

ii. Costly to Implement

Mapping QIB Certificates to Suitability Certifications (or equivalent documentation) would also be an extensive and costly exercise for the industry. At large firms, the systems that maintain these documents are typically not linked and the client naming conventions in these systems often differ. Furthermore, the systems that maintain these documents are usually different from the systems that maintain firms' research distribution lists. The systems that maintain research distribution lists maintain individual contacts at institutional clients in addition to the institutional client's legal entity information. Individual contacts may be associated with one or more affiliated legal entities, and the naming convention for those entities likely differs from the naming conventions in firms' QIB and Suitability Certification systems. Consequently, any effort to map QIB Certificates to Suitability Certifications, and in turn to map the result to a firm's research distribution list by legal entity, would be a complex matching exercise requiring manual research on each client, standardization of naming conventions, and technology builds to link the various systems. Because the industry has a wide range of systems challenges, it is difficult to estimate the average cost of implementation of the Proposed Exemption. Implementation costs, however, are likely to be high and may reach as much as $5 million, as estimated by one large firm.

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[5] *See* 17 C.F.R. § 230.144A.

[6] Broker-dealers that in the aggregate own and invest on a discretionary basis at least $10 million of securities of issuers that are not affiliated with the dealer are eligible to sign a QIB Certificate.

Moreover, because the universe of QIB Certificates does not mirror the universe of Suitability Certifications on file, firms ultimately may be forced to develop yet another certification specific to debt research. Finally, conducting this costly data mapping exercise and implementing related systems changes is not necessary to protect investors who have already indicated their sophistication by stating that they exercise independent judgment in evaluating investment decisions. Rather, such measures would create unnecessary confusion and potentially prevent certain sophisticated institutions from obtaining institutional debt research, as firms may be forced to conclude that the costs of relying on the Proposed Exemption are not worth the benefits.

C. Suggested Alternative Approach

i. Primary Option – FINRA Suitability Rule

In sum, SIFMA is concerned that the Proposed Exemption is impractical in many respects and may disadvantage institutional investors. For these reasons, for *non-natural person* clients, SIFMA continues to believe that the institutional exemption should be based on FINRA Rule 2111. FINRA should recognize that clients who have affirmatively indicated that they are capable of, and are in fact, exercising independent judgment with respect to recommended securities transactions also are capable of evaluating, and indeed wish to receive, institutional debt research.

ii. Alternative Option – Sophistication of Order Placer

Any alternate approach should look to a standard based on the sophistication of the order placer, rather than relying on the combination of two different standards that were developed for other purposes. Specifically, if FINRA chooses not to base the institutional exemption on FINRA Rule 2111, we strongly recommend that it apply the exemption at the order placer, rather than the account, level. If the suitability analysis is appropriate for recommendations at the order placer level, it follows that this level should be appropriate for an even less personalized form of communication like a research report. Otherwise, a client who is an institutional client of a firm for purposes of FINRA Rule 2111 may not be permitted to use the institutional debt research produced by that firm to make decisions about orders for its underlying accounts.

SIFMA recognizes FINRA's concerns that not all order placers should be treated as institutions, and submits that the following institutions are sophisticated and fully capable of receiving institutional research, as they do today:

- Institutions with $100 million in assets or institutions that in the aggregate own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity (*i.e.,* QIBs);
- Registered broker-dealers and banks, savings and loan associations, insurance companies and registered investment companies;
- Investment advisers 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);
- Institutions with $50-$100 million in assets, ***provided*** they are represented by an independent investment adviser; and

- Institutions, such as universities, regulatory and government entities, that use research for a non-investment (*e.g.*, academic) purpose.

As under FINRA Rule 2111, firms should be required to demonstrate compliance with the above standard, but have the flexibility to choose the form of documentation that best serves their client needs.

This alternative proposal is similar to FINRA Rule 4512(c), with three important caveats. First, natural persons would not be included in the exemption. Second, firms would need to evidence that institutions with $50-$100 million in assets are represented by an independent investment adviser. As a result, in order to receive institutional debt research, smaller institutions like municipalities and charitable organizations, for example, would need to be represented by an independent third party charged with analyzing the institutional debt research on their behalf. Third, the proposal would recognize the academic benefits of institutional debt research.

Even though it would still take time for firms to implement this alternative criteria, firms could more readily adapt existing systems built for FINRA Rule 2111. More important, many sophisticated institutional clients who receive institutional research today could continue to receive that research without disruption. As the Proposed Rule indicates, any institutional investor that prefers to receive only those debt research reports that are eligible to be provided to retail investors would still be able to "opt in" to retail research.

III. SEPARATION OF PRINCIPAL TRADING FROM RESEARCH DEPARTMENT – RESEARCH BUDGET & EVALUATION/COMPENSATION

A. Summary of the FINRA Proposal

Except as otherwise provided in the Proposed Rule, FINRA is proposing to prohibit consideration of revenue and input from a firm's principal trading operations into various aspects of the operations of a firm's research department, including research department budgetary and evaluation/compensation decisions, and prohibit the consideration of contributions to a member's principal trading activities in determining analyst compensation.

B. Concerns with the FINRA Proposal

SIFMA has concerns about three specific provisions in the Proposed Rule as it relates to research for which the institutional exemption is not applicable. In particular, we are concerned about Section (b)(3)(B) of the Proposed Rule which would prohibit consideration of revenues derived from principal trading activities in determining the budget for research, Section (b)(3)(C) which would prohibit the consideration of contributions to a member's principal trading activities in compensating debt research analysts, and Section (b)(3)(D) which would prohibit the consideration of input from personnel engaged in principal trading activities in evaluating debt research analysts.

i. Research Budgetary Considerations

Firm research departments are not revenue generating businesses, nor do they have unlimited resources to allocate to cover issuers and debt products. Instead, their operations depend upon the Firm's allocation of adequate funds to meet their resourcing requirements. As part of establishing a Research department's budget, senior management needs to understand not only the demand for resources, but also the corresponding size of the expected business, both overall as well as at the asset class level. Given that sales and trading revenue cannot be practically segregated, the Proposed Rule would prohibit research management from considering the revenue from both sales/trading and investment banking - the primary sources of funding of research. SIFMA is not challenging the inability to consider investment banking revenue given this is consistent with the FINRA equity research rule. However, when this restriction is coupled with the inability to consider sales/trading revenue, it would virtually prohibit research management from considering revenue altogether in making research budget decisions.

The Proposed Rule recognizes the importance of allowing sales and trading personnel to provide input regarding the "demand for and quality of debt research, including product trends and client interests." However, by prohibiting the consideration of this revenue against those demands for resources, the Proposed Rule eliminates any ability of research management to assess the legitimacy of that input. The allocation of the research department's resources to a particular asset class (*e.g.* mortgage research, high yield research) will be and should be influenced by the size and profitability of the respective market. Eliminating the consideration of sales and trading revenue from the research department budget determination will cripple research and Firm management's ability to align research resources with client demands. Decisions would be based only on expressed client needs and demands, without the ability to consider whether there is actually a volume of market and client interest sufficient to buttress such demands.

Furthermore, we do not believe that the potential harm to the research budget decision process that could result from the Proposed Rule is outweighed by the potential benefit. In our view, we find it challenging to construct a scenario in which a budget decision, which is made by senior management with respect to the overall department, could inappropriately influence the content of research, particularly given the other safeguards in the Proposed Rule, which SIFMA firmly supports.

ii. Research Evaluation and Compensation Considerations

a. <u>In General</u>

Research management currently relies on input from sales and trading to assist them in evaluating whether analysts' research reports and services are valued by clients. Determining the performance of fixed income analysts and their recommendations is more complex than in the equity markets. For example, there are limited buy-side surveys providing input on fixed income research analysts, and many of these surveys relate to analyst teams and not individual performers. In addition, unlike equity research, where research management can objectively measure the accuracy of an analyst's price targets and estimates, it is challenging to objectively ascertain the performance of debt research analysts' recommendations, even when fixed income securities are rated, which is not always the case.

Although SIFMA appreciates that the Proposed Rule would permit sales personnel to provide input to research management in order to convey client feedback and also would permit consideration of contributions to a member's sales activities, personnel engaged in principal trading activities would be specifically prohibited from providing the same type of input. As mentioned above, SIFMA's key concern is with the reference to "principal trading" given that the fixed income markets operate primarily on a principal basis. If principal trading as used in the Proposed Rule is meant to encompass virtually all trading activities, we are concerned about the broad impact this will have on research management's ability to appropriately evaluate and compensate fixed income research analysts.

Fixed income traders have significant interaction with a firm's clients, and in many situations clients interact with traders to the exclusion of a firm's sales team. Clients will often request meetings with debt research analysts and traders in order to obtain an overview of a particular issuer or sector from the analyst and of the market from the trader. When the client ultimately determines a course of action, they will often convey their view of the value of the research analyst's analysis directly to the trader. Prohibiting fixed income traders from conveying such input to research management, and prohibiting research management from considering such activities when determining compensation, will eliminate valuable information that is used today to help evaluate the impact and value of debt research analysts to the firm's clients.

It would be difficult for research management to find a substitute for the feedback they receive today from traders. Research management does not have the capacity to contact a sufficient number of clients to obtain informed views on individual analysts, nor is research management able to rely solely on research and sales personnel to elicit the type and quality of comments that client facing trading personnel receive on a daily basis. In any case, SIFMA believes the Proposed Rule contains sufficient provisions to mitigate potential conflicts of interest that could arise if trader input were permitted. For example, the Proposed Rule would prohibit compensation decisions from being based upon specific trading transactions. The Proposed Rule also would require that the compensation of each debt research analyst must be reviewed and approved by a committee that reports to the firm's board of directors, that such committee not include trading personnel, that each compensation determination must consider the analyst's individual performance, including the quality of the analyst's research, and that the basis for determining the compensation must be documented – all requirements that SIFMA supports and agrees will help to mitigate potential conflicts of interest.

b. <u>Compatibility with Other Regulatory Requirements – CFTC Rules</u>

SIFMA would like to draw FINRA Staff's attention to the recently implemented rule from the CFTC addressing conflicts of interest between derivatives research analysts and sales and trading.[7] Similar to FINRA, the CFTC was concerned with potential conflicts of interest if input from sales and trading personnel were considered in the compensation determination process for derivatives research

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[7] *See Swap Dealer and Major Swap Participant Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; Futures Commission Merchant and Introducing Broker Conflicts of Interest Policies and Procedures; Swap Dealer, Major Swap Participant, and Futures Commission Merchant Chief Compliance Officer, available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister022312b.pdf *(last visited Jan. 3, 2013).*

analysts. The CFTC addressed these concerns in its final rule by permitting input only to the extent it is reflective of client feedback, similar to the Proposed Rule as it relates to input from sales personnel. However, the CFTC rule did not draw a distinction between sales and trading, recognizing that many traders interact frequently with clients.[8] Given that many firms have debt research analysts who will be subject to both the FINRA debt research rule and the CFTC conflict of interest rule because of the nature of their research, it will create confusion and implementation challenges if the FINRA rule, unlike the CFTC rule, does not permit any trader feedback in evaluating debt research analysts.

C. Suggested Alternative Approach

The fixed income market is a principal trading based market, and very little trading activity is conducted on an agency basis. Unless defined more precisely, persons engaged in "principal trading" could encompass virtually all persons engaged in debt trading activities. If FINRA continues to believe that the other protections of the Proposed Rule are not sufficient to address potential conflicts, SIFMA suggests that FINRA focus on trading that is not client driven – *i.e.*, conflicts with respect to proprietary trading activities.

Accordingly, SIFMA recommends that the Proposed Rule define "principal trading" as:

- "engaging in proprietary trading activities for the trading book of a member but does not include transactions undertaken as part of underwriting related, market-making related, or hedging activities, or otherwise on behalf of clients."

IV. <u>ADDITIONAL COMMENTS – ROAD SHOW PROHIBITION</u>

A. Summary of the FINRA Proposal

FINRA proposes to prohibit debt research analyst "participation in road shows ... related to an investment banking services transaction" ("Road Show Prohibition").[9] This is the same language as NASD Rule 2711, which applies to equity research analysts. NASD (n/k/a FINRA) has interpreted this requirement to permit equity research analysts to dial into road shows from a remote location in listen-only mode and not be identified as being present ("Equity Research Analyst Interpretation").[10] SIFMA assumes that the Equity Research Analyst Interpretation also will apply to debt research analyst activities.

B. Concerns with the FINRA Proposal

Even assuming that the Equity Research Analyst Interpretation will apply to debt research analyst activities, SIFMA has concerns that applying a road show prohibition to the activities of debt research analysts does not take into consideration key differences between equity and debt research departments and potentially could result in unintended negative effects. Equity research analysts

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[8] *Id. at pp. 98 and 222.*

[9] *See* FINRA Regulatory Notices 12-42 and 12-09.

[10] *See* NASD Notice to Members 07-04.

typically cover a fixed and far more limited number of companies within a particular sector, and as a result, typically know and have ongoing professional relationships with management of issuers under coverage. Debt research analysts, on the other hand, have constant and substantial turnover of issuers under coverage. Accordingly, even though equity research analysts can only hear - but not see - a deal road show, they are otherwise familiar with issuer management and so the ability to physically view management in this context is usually not of critical importance. By contrast, the issuer coverage universe of debt research analysts is wider and more fluid.

There is, in addition, a long tradition of management making efforts to grant equity analysts the opportunity to engage in Q&A with management, interview mid-level and divisional heads, and attend investor days. No such tradition exists for debt analysts. It is also worth noting that roughly one third of high yield issuers are privately held entities and/or have been spun off from another firm (*i.e.*, previously were part of a larger organization). For such firms there is no historical track record of operating or financial performance and no prior management history.

In a deal context, the road show - typically a luncheon -- is often the only opportunity for a debt research analyst to view an issuer's management presentation. Actually seeing a management presentation is important in order to understand the nuance of the message, to follow the presentation in relation to materials that may be in the room (and may or may not be available to dial-in participants), and to evaluate the credibility of management's business plan and outlook. Unlike in the equity deal context, debt deals typically take place at a quick pace with issuers having a crowded road show calendar - often spending a single day in each city. It is, therefore, usually impractical for management to have separate in-person meetings with debt research analysts. Additionally, there are often significant challenges to dialing in remotely as often no phone line will be available, and the questions being posed by audience members cannot be heard over the phone line.

The concern is more pronounced in certain segments of the debt markets, including U.S. high-yield and emerging markets, which have seen record issuances in recent years. In particular, with respect to private companies in these markets, there may be no prior public information available and, as noted, there may be no access to management until the roadshow itself. In a deal setting, it is critical for a debt research analyst to rapidly get up to speed not just on the transaction, but on the issuer. In our view, not permitting passive attendance at the road show would unduly hamstring debt research analysts' ability to formulate robust and thoughtful insights.

C. Suggested Clarification

SIFMA is requesting that FINRA revise the proposed rule to specifically permit debt research analysts to passively attend (both remotely and in-person) deal road shows. We understand that passive attendance would not allow debt research analysts to participate in the road show presentation, sit on the dais, identify themselves as being an analyst, pose questions or otherwise make comments from the audience.

V. EFFECTIVE DATE FOR THE PROPOSED RULE

SIFMA requests that firms be provided with sufficient time to make the necessary system, policy and procedural changes to implement the final rule. Depending on the requirements of the final rule, SIFMA estimates that firms will need from 12 to 18 months after SEC approval. In addition to systems issues, large firms will be devoting considerable time and resources throughout 2013 to Dodd-Frank compliance, clients may be confused by yet another outreach effort coming so soon on the heels of FINRA 2111 and Dodd-Frank, and any changes to Research budget and compensation processes must be developed and implemented well in advance of the year-end process, which at most large firms begins in the fourth quarter.

* * * *

SIFMA appreciates the opportunity to comment on the Proposed Rule. SIFMA reiterates our support for many of the proposed provisions, subject to the concerns outlined above. SIFMA would be pleased to discuss any of these points further, and to provide additional information you believe would be helpful. Please feel free to contact me at (202) 962-7386, if you have any questions or comments.

Sincerely,

Kevin A. Zambrowicz
Managing Director, Associate General Counsel, SIFMA

Exhibit 3a

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

Financial Industry Regulatory Authority

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 report[3] 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.

Exhibit 3b

Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules

December 2005

TABLE OF CONTENTS

EXHIBITS

Exhibit A – SRO Rules
NYSE Rules 472 and 472(k) Interpretation, 351, 344 and 344 Interpretation, and 345A

NASD Rules 2711, 1050 and 1120

Exhibit B – July 2002 Joint Memorandum
NYSE Information Memo No. 02-26 (June 26, 2002) and NASD *Notice to Members* 02-39 (July 2002)

Exhibit C – March 2004 Joint Memorandum
NYSE Information Memo No. 04-10 (Mar. 9, 2004) and NASD *Notice to Members* 04-18 (Mar. 2004)

Exhibit D – Chart Comparing SRO Rules and Global Settlement

INTRODUCTION

Beginning in 2002, the New York Stock Exchange ("NYSE") and NASD (together, "the SROs") implemented a series of rule changes ("SRO Rules") to improve objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions. The rules were intended to restore public confidence in the validity of research and the veracity of research analysts, who are expected to function as unbiased intermediaries between issuers and the investors who buy and sell their securities. The trustworthiness of research had eroded due to the pervasive influences of investment banking and other conflicts that had manifest themselves during the market boom of the late 1990s.

Generally, the SRO Rules require clear, comprehensive and prominent disclosure of conflicts of interest in research reports and public appearances by research analysts. The rules further prohibit certain conduct – investment banking personnel involvement in the content of research and determination of analyst compensation, for example – where the conflicts are considered too pronounced to be cured by mere disclosure. Together with the Securities and Exchange Commission's ("SEC" or the "Commission") Regulation Analyst Certification and the settlement terms of certain enforcement proceedings, including the "Global Settlement" among the SROs, the Commission, the North American Securities Administrators Association ("NASAA") and ten[1] of the largest investment banks, the SRO Rules have resulted in sweeping changes to the way firms produce research, utilize and compensate research analysts, and structure the operations of their research and investment banking departments. Evidence suggests that these reforms have resulted in more objective, reliable and valuable research for investors. However, the new rules also have added costs and administrative burdens to firms and contributed to a reduction in research coverage and analyst compensation.

The SEC has requested that the SROs submit this joint report on the operation and effectiveness of the SRO Rules, including any staff recommended changes to the current rule provisions.[2] The report contains six sections. Section I provides background on the conflicts that gave rise to the SRO Rules and sets forth the history of the SRO rulemaking and other regulatory initiatives with respect to research-related activity. Section II discusses the registration and qualification requirements for research analysts and their supervisors, including statistics concerning the levels of registration and qualification. Section III contains a review of SRO examinations, sweeps and enforcement activity since the SRO Rules became effective. Section IV discusses the impact of the SRO Rules as reported in academic studies and media reports and commentary. Section V contains a detailed review of the SRO Rule provisions, including member feedback and recommended changes. Finally, Section VI is the Conclusion.

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1 In August 2004, two additional firms settled with regulators under the same terms as the April 2003 Global Settlement.

2 The views provided in this report are solely those of the NASD and NYSE staffs and have not been endorsed by the Board of Governors of NASD or the Board of Directors of the NYSE.

I. BACKGROUND

A. Conflicts that Led to Regulation

Prior to implementation of the SRO Rules, research analysts were subject to a host of pressures and influences that could – and in many instances, did – compromise the objectivity of their research. The primary biasing forces came from investment bankers who pressured research analysts to speak favorably of current and prospective clients and, with management acquiescence, linked analysts' compensation directly to their role in landing lucrative investment banking deals. In the succinct words of a retired Wall Street research analyst who testified before Congress in the summer of 2001: "Investment banking now dominates equity research."[3] Other conflicts also existed, most notably analysts' personal financial interest in the securities they covered and their firms' ownership positions in covered securities. In addition, research analysts were subject to pressure from subject companies and their major shareholders to maintain favorable ratings.[4]

In testimony before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (the "Subcommittee"), SEC Acting Chair Laura Unger identified a number of then commonplace practices that illustrated the conflicts of interest faced by research analysts.[5] First, research analysts were compensated based on their contributions in support of investment banking transactions and the profitability of that unit. To that end, research analysts typically consulted on possible transactions, participated in road shows and initiated favorable coverage on current and prospective investment banking clients. Moreover, investment bankers at some firms evaluated research analysts for compensation purposes, particularly bonuses.

Second, research analysts provided research reports on companies underwritten by the analysts' firms. Third, research analysts invested in pre-initial public offering ("IPO") private placements of companies they subsequently covered and for which their firms had acted as underwriters. Fourth, research analysts provided investment bankers with prior notice of changes in recommendations. Fifth, research analysts issued "booster-shot" research reports or "buy" recommendations close to expiration of the lock-up period. Such reports served to generate buying interest in the stock and help increase the price while the firm, its clients, or the analysts sold their shares. Sixth, research analysts owned securities in the companies they covered and either failed to disclose those interests or did so in an opaque manner. In some cases, analysts executed trades for their personal accounts that were contrary to the recommendations in their research reports.[6] Finally, analysts rarely revealed any conflicts of interest to investors during

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3 *Analyzing the Analysts: Hearings Before the H. Comm. On Capital Markets, Insurance, and Government Sponsored Enterprises of the Comm. On Financial Services*, 107th Cong., at 243 (2001) (prepared testimony of Ronald Glantz, retired) ("Glantz Testimony").

4 *See, e.g.*, *Analyzing the Analysts* at 251 (prepared testimony of Charles L. Hill, Director of Financial Research, Thomson Financial/First Call) ("analyst objectivity is subject to pressure from four different places": (1) analysts themselves; (2) investment banking; (3) public companies; and (4) institutional shareholders).

5 *Analyzing the Analysts* at 227-240 (written testimony of Laura S. Unger, Acting Chair of the Securities and Exchange Commission) ("Unger Testimony").

6 *Id.* at 233. *See also, e.g.*, *Analyzing the Analysts* at 160 (prepared testimony of Gregg Hymowitz, Founder and Principal of EnTrust Capital Inc.); Glantz Testimony, *supra* note 3; *Analyzing the Analysts* at 266

media appearances in which they routinely recommended securities, and while most firms affirmatively stated that they acted as an underwriter or market maker, others merely stated that they "may" have acted in that capacity.[7]

While these conflicts were not new, they had deepened in the existing market environment. As another witness who testified before the Subcommittee observed:

> [T]he pressures on the analyst have escalated in an environment where penny changes in earnings-per-share forecasts make dramatic differences in share price, where profits from investment-banking activities outpace profits from brokerage and research, where the demographics of the investors who use and rely on sell-side research have shifted, and where investment research and recommendations are now prime-time news.[8]

The industry itself seemed to recognize that the conflicts in research had intensified. As the SROs began rulemaking, discussed in Section I.B below, the industry took steps on its own to address these conflicts. Several firms amended or adopted policies regarding research analysts' ownership of securities of covered companies.[9]

In addition, in June 2001, the Securities Industry Association ("SIA") endorsed a compilation of "best practices"[10] designed to restore the integrity of research and "reaffirm that the securities analyst serves only one master: The investor."[11] The practices were compiled by an ad hoc committee of senior research professionals from the SIA's largest member firms, and included several key recommendations focused on analyst compensation and stock ownership, relations

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(prepared testimony of Adam Lashinsky, Silicon Valley Columnist, The Street.com); *Id.* at 253 (prepared testimony of Matt Winkler, Editor-in-Chief, Bloomberg News).

7 Unger Testimony, *supra* note 5, at 234.

8 *Analyzing the Analysts* at 196 (statement of Thomas A. Bowman, CFA, President and Chief Executive Officer, The Association for Investment Management and Research).

9 For example, Merrill Lynch, Edward Jones and Credit Suisse First Boston announced new policies prohibiting analysts from owning shares in companies they follow. *See id.* at 120 (opening statement of Honorable Paul Kanjorski). Goldman Sachs initiated a policy that would permit analysts to own shares in companies they cover under the following conditions: (1) approval of management and the firm's compliance committee would be required for purchases; (2) purchases would be subject to a minimum 30-day holding period; (3) analysts would be permitted to purchase only stocks that were rated a "trading buy" or already on the firm's recommended list; (4) analysts would be prohibited from selling securities unless they were rated below a "trading buy"; and (5) there would be a twenty-four hour restriction imposed after a change in the rating of a company. *See* Adam Lashinsky, *Wall Street's Discovery of Ethics Is Too Little, Too Late*, TheStreet.com, July 10, 2001, http://www.thestreet.com/markets/adamlashinsky/1486552.html.

Prior to this time, Robertson Stephens had implemented a policy in September 2000 pursuant to which: (1) analysts cannot own stock in companies they cover, and (2) if they already own shares in a company they want to cover, they are required to sell their shares or place them in a blind trust. *Id*.

10 *See Best Practices for Research*, June 2001, and Press Release, *SIA Endorses "Best Practices" To Ensure Ongoing Integrity of Research* (June 21, 2001); *Analyzing the Analysts* at 172 (statement of Marc E. Lackritz, President, SIA).

11 *See Best Practices for Research*, June 2001, and Press Release, *supra* note 10.

with investment banking units and disclosures: (1) research departments should not report to investment banking or any other business units that might compromise their independence, and there should be no outside or investment banking approval of the analyst's opinions or recommendations; (2) analysts' compensation should not be directly linked to specific investment banking transactions, sales and trading revenues or asset management fees; (3) personal financial interests in covered securities should be disclosed; and (4) analysts should not trade contrary to their recommendations, except after consultation with research department, legal and/or compliance personnel.[12]

Similarly, in July 2001, the Association for Investment Management and Research ("AIMR"), which is now named the CFA Institute, released a white paper discussing a wide range of potential influences on the objectivity of brokerage-firm research.[13] The white paper also set forth recommendations for a more objective research environment, including: (1) brokerage firm management must foster a corporate culture that fully supports independence and objectivity; (2) firms must establish or reinforce separate reporting structures so that investment banking can never influence a research report or investment recommendation; (3) firms should implement compensation arrangements that do not link analysts' compensation to investment banking work; and (4) firms should require public disclosure of actual conflicts of interest to investors.[14]

However, the guidelines set forth by the industry associations lacked the force and effect of law. Moreover, some lawmakers felt the voluntary industry efforts were inadequate in scope. As Congressman Richard Baker remarked on the second day of hearings before the Subcommittee, "[T]he existing industry association best-practices proposal doesn't go far enough to address the problems, nor, I might add, do subsequent actions taken by individual firms . . . ."[15] Congressman John LaFalce expressed that "more disclosure of these conflicts, in itself will not suffice to protect the individual investor."[16]

B. Summary of Rule Filings and Other Regulatory Actions

1. NASD/NYSE Rule Filings

The SROs enacted the research analyst conflict rules in two primary tranches and, more recently, adopted additional amendments prohibiting analysts from participating in road shows. *See* Exhibit A for the complete text of the SRO Rules. In addition, the SROs supplemented their rulemaking with two joint memoranda that provided interpretive guidance to their members on a number of issues. *See* Exhibits B and C for the joint interpretive memoranda. The NASD and NYSE rules and interpretations are virtually identical and are intended to operate uniformly.

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12 *Id.*

13 *See Preserving The Integrity of Research*, Association for Investment Management and Research (July 2001), and CFA Institute Press Release, *Global Investment Association AIMR Issues Report On Analyst Objectivity* (July 11, 2001).

14 *Id.*

15 *Analyzing the Analysts* at 210 (opening statement of Honorable Richard H. Baker, Chairman).

16 *Id.* at 219 (statement of Honorable John J. LaFalce, Ranking Committee Member).

Round 1 Amendments

In February 2002, the SROs filed the first round of proposed SRO Rules ("Round 1 Amendments") – amendments to NYSE Rules 351 ("Reporting Requirements") and 472 ("Communications with the Public") and new NASD Rule 2711("Research Analysts and Research Reports")[17] – which implemented basic reforms to separate research from investment banking and to provide more extensive disclosure of conflicts of interest in research reports and public appearances.

Generally, the Round 1 Amendments, approved by the SEC on May 10, 2002,[18] achieved the following:

- imposed structural reforms to increase analyst independence, including prohibiting investment banking personnel from supervising analysts or approving research reports;
- prohibited offering favorable research to induce investment banking business;
- prohibited research analysts from receiving compensation based on a specific investment banking transaction;
- required disclosure of financial interests in covered companies by the analyst and the firm;
- required disclosure of existing and potential investment banking relationships with subject companies;
- imposed quiet periods for the issuance of research reports after securities offerings managed or co-managed by a member;
- restricted personal trading by analysts;
- required disclosure in research reports of data and price charts that help investors track the correlation between an analyst's rating and the stock's price movements; and
- required disclosure in research reports of the distribution of buy/hold/sell ratings and the percentage of investment banking clients in each category.

The Round 1 Amendments were phased-in incrementally to provide members time to implement necessary policies, procedures, systems and other measures to comply with the new

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[17] On February 8, 2002, NASD filed SR-NASD-2002-021. The NYSE filed SR-NYSE-2002-09 on February 27, 2002. On March 7, 2002, NASD filed Amendment No. 1 to SR-NASD-2002-021. The proposals were published for comment in the Federal Register on March 14, 2002. *See* Securities Exchange Act Release No. 45526 (Mar. 8, 2002), 67 FR 11526 (Mar. 14, 2002). On May 1, 2002, NASD filed Amendment No. 2 to SR-NASD-2002-021, and the NYSE filed Amendment No. 1 to SR-NYSE-2002-09.

[18] *See* Securities Exchange Act Release No. 45908 (May 10, 2002), 67 FR 34968 (May 16, 2002) (order approving SR-NYSE-2002-09 and SR-NASD-2002-021).

requirements. Most provisions of the SRO Rules went into effect on July 9, 2002; others became effective on September 9, 2002 or November 6, 2002.[19]

Round 2 Amendments and Sarbanes-Oxley

On July 29, 2003, the SEC approved a second set of amendments to the SRO Rules ("Round 2 Amendments")[20] that achieved two purposes. First, the Round 2 Amendments implemented SRO initiatives to further promote analyst objectivity and transparency of conflicts in research reports. The need for some of these additional measures had come to light in the course of joint sweeps undertaken by the SROs and SEC to examine members' research practices for compliance with industry regulations.[21] Among the most significant SRO initiatives included in the Round 2 Amendments were provisions that:

- further insulated analyst compensation from investment banking influence by requiring that a compensation committee, without investment banking representation, review and approve compensation of research analysts and that such compensation be based on the quality of research produced;

- prohibited analysts from participating in the solicitation of investment banking business;

- prohibited analysts from issuing a research report or making a public appearance concerning a subject company around the time of a lock-up expiration, termination or waiver;

- required members to publish a final research report when they terminate coverage of a subject company and provide notice of such termination;

- imposed registration, qualification and continuing education requirements on research analysts (detailed in Section II below); and

- created an exemption from certain rule provisions for firms that engage in limited underwriting activity.

Second, the Round 2 Amendments implemented changes mandated by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[22] Sarbanes-Oxley required adoption by July 30, 2003 of rules "reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances," and set forth certain specific rules to be promulgated. Many of those rules had already been adopted in the first round

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[19] Certain small firms with limited underwriting activity were granted delayed effectiveness from certain provisions of the SRO Rules until July 2003, at which time a limited exemption was adopted and codified.

[20] Securities Exchange Act Release No. 48252 (July 29, 2003), 68 FR 45875 (Aug. 4, 2003) (order approving SR-NYSE-2002-49 and SR-NASD-2002-154).

[21] In April 2002, the SROs and the SEC established a Joint Task Force to review practices of designated firms with regard to research reports and recommendations on issuers for which firms had provided or sought investment banking services from January 1999 through April 2002.

[22] *See* Section 15D(a) of the Exchange Act, 15 U.S.C. 78o-6.

of SRO rulemaking. The Round 2 Amendments therefore implemented those specific Sarbanes-Oxley rules that did not already exist and conformed the language of the SRO Rules as necessary. Most notably, the Round 2 Amendments satisfied the following Sarbanes-Oxley requirements:

- modified the definition of "research report" to delete the requirement that the communication contain a recommendation;
- extended quiet periods after securities offerings to all firms that participated in the offering as an underwriter or dealer;
- required disclosure of a client relationship and non-investment banking compensation received by a firm from a covered company; and
- prohibited retaliation against research analysts for publishing unfavorable research on an investment banking client.

As with the Round 1 Amendments, the Round 2 Amendments were phased-in incrementally. Most provisions went into effect on September 29, 2003, while certain other provisions did not become effective until October 27, 2003 or January 26, 2004.[23]

Recent Amendment Prohibiting Analyst Participation in Road Shows

On April 21, 2005, the Commission approved an amendment to the SRO Rules that prohibits research analysts from participating in a road show related to an investment banking services transaction and from communicating with current or prospective customers in the presence of investment banking department personnel or company management about such an investment banking services transaction.[24] Additionally, the amendment prohibits investment banking personnel from directing a research analyst to engage in sales and marketing efforts and other communications with a current or prospective customer about an investment banking services transaction.

By prohibiting research analysts from participating in road shows and communicating with customers in the presence of investment bankers or company management, the amendment further reduces pressure on research analysts to give an overly optimistic assessment of a particular transaction. It also removes any suggestion to investors in attendance at a road show that the analyst will give positive coverage to the issuer or that the analyst endorses all of the views expressed by the company or investment banking department personnel.

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[23] In 2004, the SROs delayed the effectiveness of certain disclosure provisions in the rules until April 26, 2004. *See* Securities Exchange Act Release No. 49119 (Jan. 23, 2004), 69 FR 4337 (Jan. 29, 2004) (notice of immediate effectiveness of SR-NASD-2004-003 and SR-NYSE-2004-01).

[24] Securities Exchange Act Release No. 51593 (Apr. 21, 2005), 70 FR 22168 (Apr. 28, 2005) (order approving SR-NASD-2004-141 and SR-NYSE-2005-24). As defined under NASD Rule 2711(a)(2) and NYSE Rule 472.20, "investment banking services" includes, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs (private investment, public equity transaction), or similar investments; or serving as placement agent for the issuer.

The amendment expressly permits research analysts to educate investors and member personnel about a particular offering or other transaction, provided the communication occurs outside the presence of company management and investment banking department personnel. Such permissible communications to investors and internal personnel must be fair, balanced and not misleading, taking into account the overall context in which such communications are made.[25]

The amendment became effective on June 6, 2005.

2. Joint Memoranda and Interpretations

The Commission noted in its approval order of May 10, 2002 that the SROs would provide interpretive guidance on certain provisions of the SRO Rules. Accordingly, contemporaneous with the first effective date of the new rules, the SROs issued a joint memorandum ("July 2002 Joint Memorandum") providing interpretive guidance on a number of topics, including: the definitions of "investment banking services" and "research report"; public appearances; quiet periods; the applicability of the SRO Rules to third-party research; the prohibition on certain forms of research analyst compensation; restrictions on personal trading by analysts; and requisite disclosures, including the distribution of ratings and price charts (*see* Exhibit B).[26]

In March 2004, the SROs issued a second joint memorandum ("March 2004 Joint Memorandum") to provide further interpretive guidance on the amended SRO Rules (*see* Exhibit C).[27] That memorandum generally addressed issues related to the definition of "research report"; the applicability of the "gatekeeper," blackout and quiet periods provisions; and the scope and prominence of certain disclosure requirements.

The SROs continue to work together on interpretive issues.

3. Other Regulatory Initiatives

Regulation AC

On February 6, 2003, the SEC adopted Regulation Analyst Certification ("Regulation AC"), which took effect on April 14, 2003.[28] Regulation AC generally requires broker-dealers to include in a research report certifications by the analysts who are principally responsible for

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25 The prohibition on research analysts' participation in road shows does not prohibit certain analysts' communications that are permitted under the federal securities laws. *See* 17 CFR 230.137, 230.138 and 230.139 (research reports issued in accordance with Rules 137, 138 and 139 under the Securities Act of 1933).

26 *See* NYSE Information Memo No. 02-26 (June 26, 2002), and NASD *Notice to Members* 02-39 (July 2002).

27 *See* NYSE Information Memo No. 04-10 (Mar. 9, 2004), and NASD *Notice to Members* 04-18 (Mar. 2004).

28 *See* Regulation Analyst Certification, Securities Exchange Act Release No. 47384 (Feb. 20, 2003), 68 FR 9482 (Feb. 27, 2003). In August 2003 and April 2005, the SEC staff issued additional guidance regarding Regulation AC in a series of questions and answers on the SEC Web site. *See* SEC Responses to Frequently Asked Questions Concerning Regulation Analyst Certification, http://www.sec.gov/divisions/marketreg/mregacfaq0803.htm.

preparing the report (1) that the recommendations or views expressed in the research report accurately reflect the analysts' personal views about the subject securities and issuers, and (2) whether any part of the analysts' compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed in the research report. In addition, research analysts must certify to the accuracy of statements made in public appearances and that no part of the research analysts' compensation is tied to statements made during the public appearance. If the broker-dealer does not obtain such certification by the analysts, it must disclose this fact and promptly notify its designated examining authority. The SROs continue to examine for compliance with Regulation AC.

Unlike the SRO Rules, Regulation AC applies to both fixed-income and equity research reports and the analysts who are primarily responsible for preparing those reports. Similar to the SRO Rules, Regulation AC broadly defines a "research report" as "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."

4. Enforcement Proceedings

As the SROs engaged in rulemaking to manage and eradicate existing research conflicts, regulators brought enforcement proceedings to redress past misconduct in the area.

Merrill Lynch Settlement

In May 2002, as part of a settlement with the New York Attorney General, Merrill Lynch agreed to adopt certain changes to its equity research and investment banking activities. Among other things, Merrill Lynch agreed to completely separate analyst compensation from investment banking, prohibit investment banking input into analysts' compensation and disclose in all research reports whether it has received or is entitled to receive any compensation from a covered company over the past 12 months.

The Global Settlement

On April 28, 2003, the SEC, NYSE, NASD, NASAA and the New York Attorney General's Office announced that they had reached an agreement (the "Global Settlement") with ten investment banking firms settling actions alleging fraudulent or misleading research. The United States District Court for the Southern District of New York approved the Global Settlement on October 31, 2003[29] and an amendment to the agreement was approved in September 2004.[30]

The Global Settlement differs in structure from the SRO Rules. The former generally prohibits all communications between research and investment banking personnel, with certain express exceptions. In contrast, the SRO Rules permit all communications that are not expressly prohibited. But the key provisions of the Global Settlement and the SRO Rules are essentially

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[29] *See* SEC Litigation Release No. 18438, 2003 SEC LEXIS 2601 (Oct. 31, 2003).

[30] *See* 03 Civ. 2941 (WHP), 2004 U.S. Dist. LEXIS 19149 (S.D.N.Y. Sept. 24, 2004) (amendments to Addendum A).

the same; the few differences are noted below. A chart comparing the provisions is included as Exhibit D.

The common provisions include prohibitions on review and approval of research by investment banking; prohibitions on research analysts from soliciting investment banking business and participating in sales and marketing activities; requirements for the termination of coverage; general requirements that the compensation of a research analyst primarily responsible for the preparation of the substance of a research report be reviewed and approved by a member firm committee without investment banking representation that reports to the Board of Directors or the senior chief executive officer; and increased disclosure and transparency of potential and actual conflicts of interests and of issues related to the performance of research analysts, such as ratings, price targets and an explanation of the firm's rating system.

Some Global Settlement terms have not been explicitly or implicitly incorporated into the SRO Rules. For example, the Global Settlement requires that the work of the compensation committee be reviewed by an oversight committee of research management. Other Global Settlement requirements not incorporated by the SROs are physical separation between research analysts and investment banking; the requirement that research have its own dedicated legal and compliance staff; and requirements for firms to procure and make available for their clients independent research on listed companies that they cover.

Additionally, comparable SRO Rules and Global Settlement definitions differ in degree and scope. The definitions of "research reports" and "research analysts" are illustrative. The SRO Rules, for example, apply to all research reports produced by the SROs' members, irrespective of where or to whom they are distributed; however, the Global Settlement limits its definition of "research report" to communications furnished to investors in the United States. Also, the SRO Rules' definition of "research analyst" – the same as mandated by the Sarbanes-Oxley Act – is broader than the Global Settlement's definition of "Research Personnel," which is limited to those individuals whose primary job is the preparation of research reports.

The SRO staffs address in Section V whether they recommend incorporating additional Global Settlement terms into the SRO Rules or making any other conforming changes.

II. REGISTRATION AND QUALIFICATION REQUIREMENTS

A. Series 86/87 Examinations

As part of the Round 2 Amendments, the SEC approved rules requiring registration and qualification requirements for research analysts. The SRO Rules require an associated person[31] who functions as a research analyst on behalf of a member to register as such and pass a qualification examination. Those rules are intended to ensure that research analysts possess a certain competency level to perform their jobs effectively and in accordance with applicable rules and regulations. In the context of this requirement, the SRO Rules define "research analyst" as "an associated person who is primarily responsible for the preparation of the

[31] *See* SR-NYSE-2005-24 amending the definition of "research analyst" in NYSE Rules 344.10 and 472.40 to include "associated persons." NASD rules already separately defined "associated person."

substance of a research report or whose name appears on a 'research report,'" as that term is defined in the SRO Rules.

The SROs jointly developed and implemented the Research Analyst Qualification Examination (Series 86/87). The examination consists of an analysis part (Series 86) and a regulatory part (Series 87). Prior to taking either the Series 86 or 87, a candidate also must have passed the General Securities Registered Representative Examination (Series 7), the Limited Registered Representative Examination (Series 17), or the Canada Module of Series 7 (Series 37 or 38). Persons who were functioning as research analysts on the effective date of March 30, 2004 and submitted a registration application to NASD by June 1, 2004, had until April 4, 2005 to meet the registration requirements. There was no grandfather provision. The one-year grace period was intended to provide these analysts sufficient time to study and pass the examination without causing undue disruption in carrying out their responsibilities to their member firm and its customers.

B. Exemptions

The SRO Rules provide three exemptions from the Series 86 examination. First, there is an exemption for research analysts who have passed Levels I and II of the Chartered Financial Analyst ("CFA") examination and have either (1) completed the CFA Level II within 2 years of application or registration, or (2) functioned as a research analyst continuously since having passed the CFA Level II.[32] A second exemption is available to research analysts who have passed Levels I and II of the Chartered Market Technician Examination and produce only "technical research reports" as that term is defined under the SRO Rules.[33]

A third exemption – from both the Series 86 and Series 87 – is available to "associated persons" of a member who are employed by that member's foreign affiliate but who produce research on behalf of the U.S. member. The SROs created this third exemption in response to requests from some members with global research operations that had difficulty ascertaining whether certain foreign research analysts whose work contributed to the member's research report were "associated persons" who must meet the registration and qualification requirements under the SRO Rules.

To be eligible for the exemption, three primary conditions must be met: (1) a foreign analyst must comply with the registration and qualification requirements or other standards in an SRO-approved foreign jurisdiction whose regulatory scheme reflects a recognition of principles that are consonant with the SRO Rules and qualification standards; (2) the U.S. member must apply all of the other SROs rules and other member firm standards to the research produced by the foreign affiliate and foreign research analysts that qualify for, and rely upon, the exemption; and (3) the U.S. member must include a specific disclosure that the research report has been prepared in whole or part by foreign research analysts who may be associated persons of the member who are not registered/qualified as a research analyst with the NYSE or NASD, but instead have

32 *See* Securities Exchange Act Release No. 49464 (Mar. 24, 2004), 69 FR 16628 (Mar. 30, 2004) (order approving SR-NYSE-2004-03 and SR-NASD-2004-020).

33 *See* Securities Exchange Act Release No. 51240 (Feb. 23, 2005), 70 FR 10451 (Mar. 3, 2005) (notice of immediate effectiveness of SR-NYSE-2005-12 and SR-NASD-2005-022).

satisfied the registration/qualification requirements or other research-related standards of a foreign jurisdiction that have been recognized for these purposes by the NYSE and NASD.

Eligibility for the exemption in no way bears upon whether the foreign research analyst is an associated person of the member. And to the extent that a member can determine that a foreign research analyst is *not* an "associated person," there is no requirement to satisfy any of the SRO Rules, including the registration and qualification requirements.

Currently, the following jurisdictions satisfy the applicable SRO standards noted above: China, Hong Kong, Japan, Malaysia, Singapore, Thailand and the United Kingdom. The SROs only considered those jurisdictions submitted by the members that requested the exemption but agreed to consider additional jurisdictions on a case-by-case basis, as requested.[34]

C. Supervisory Requirements

NASD has an additional rule that requires supervisors of research analysts to pass the Series 87 examination or the NYSE Series 16 Supervisory Analyst Examination. Those who oversee the *content* of research reports must have passed either the Series 87 or the Series 16 examination. A registered principal (Series 24) who has also passed either the Series 87 or the Series 16 examination must supervise the conduct of both the Series 16 Supervisory Analyst and the research analyst. The rule became effective on August 2, 2005.[35] NYSE Rule 472(a)(2) requires that a supervisory analyst acceptable under NYSE Rule 344 approve research reports.

D. Statistics

Between April 1, 2004 and November 30, 2005, 5,599 research analysts and 418 research principals had satisfied the applicable registration and qualification requirements. The Series 86 exam was attempted 6,158 times, with an overall pass rate of 74.9%, and the Series 87 exam was attempted 8,259 times, with an overall pass rate of 89.6%. During the same period, 2,375 CFA exemptions and 34 technical analyst exemptions were granted.

III. EXAMINATIONS, SWEEPS AND ENFORCEMENT ACTIONS

The SROs continue to closely examine for compliance with the SRO Rules and rigorously pursue enforcement actions for violations of these rules. The area of research analyst conflicts remains a high priority component of the SROs' examination and enforcement programs.

A. NASD Summary

1. Member Regulation

As the SRO Rules became effective, NASD's Member Regulation Department incorporated into its routine examination program an inspection for compliance with NASD Rule 2711 and SEC Regulation AC.

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[34] The SROs will notify their membership in the event additional jurisdictions are approved.

[35] Securities Exchange Act Release No. 50162 (Aug. 6, 2004), 69 FR 50406 (Aug. 16, 2004) (order approving SR-NASD-2004-078).

Between July 2002 and November 30, 2005, NASD initiated 467 examinations reviewing firms for compliance with Rule 2711 and Regulation AC. In the course of these examinations, NASD found 110 violations of Rule 2711 and 25 violations of Regulation AC. Specifically, the Rule 2711 violations have involved: (1) failure to have adequate procedures in place to supervise the activities of research analysts with respect to conflicts of interest, in violation of Rule 2711(i) (47 of 467 examinations); (2) failure to adequately comply with the disclosure requirements regarding research reports and public appearances, in violation of Rule 2711(h) (24 of 467 examinations); (3) failure to file the Annual Attestation, in violation of Rule 2711(i) (20 of 467 examinations); (4) personal trading of the subject companies' securities in the analyst's account within the restricted time period, in violation of Rule 2711(g) (10 of 467 examinations); and (5) failure to comply with restrictions on communications with the subject company, in violation of Rule 2711(c) (9 of 467 examinations).

Of the 135 violations of Rule 2711 and Regulation AC found to date, 27 have resulted or are expected to result in an Acceptance, Waiver and Consent, seven have resulted in a formal complaint, 18 have resulted in a compliance conference, 81 have resulted in a Letter of Caution, and two remain under investigation.

2. Enforcement

As of November 30, 2005, NASD Enforcement has settled 29 cases involving Rule 2711 violations and two cases involving violations of Rule 1050, the analyst registration rule. By far, the vast majority of settled Enforcement actions have involved violations of the disclosure requirements of Rule 2711(h), encompassing over 265 research reports. Specific violations of this provision include: (1) failure to disclose ownership of shares of subject companies; (2) failure to disclose compensation for investment banking services from the subject company; (3) failure to disclose market making activity; (4) use of conditional language in making the requisite disclosures; (5) failure to provide sufficient price charts; (6) failure to disclose the distribution of buy, hold and sell recommendations; (7) failure to provide information about the valuation methods used; (8) failure to define recommendations; and (9) failure to provide disclosures required by Rule 2210.

Other settled Enforcement cases have involved such violations of Rule 2711 as (1) failure to maintain supervisory procedures pursuant to Rule 2711(i) (113 research reports); (2) communications with subject companies in violation of Rule 2711(c) (17 research reports); and (3) failure to abide by the personal trading restrictions under Rule 2711(g) (21 research reports). In addition, two cases involved analysts offering favorable research reports in exchange for compensation in violation of Rule 2711(e), and one case involved a firm's failure to provide notice of termination of coverage and issue final research reports with respect to seven subject companies, in violation of Rule 2711(f).

Sanctions in the settled Enforcement cases have included fines ranging from $10,000 to $50,000, disgorgement, suspensions and bars in all capacities. In addition, NASD Enforcement has settled with two firms for failure to timely apply for research analyst designation in violation of Rule 1050. These two cases involved 56 analysts and 325 research reports, and each firm was censured and fined (one in the amount of $100,000; the other, $150,000).

There are currently two pending complaints against firms and a number of open investigations involving suspected violations of Rule 2711. These matters involve many of the same compliance issues discussed above, including allegations of failure to meet disclosure obligations and of transgressing the personal trading restrictions. In addition, in summer 2005, the SROs launched a joint sweep of 30 firms to review their compliance with NASD Rules 2711 and 1050 and NYSE Rule 344 in the context of research prepared on behalf of the members by foreign analysts. That review is ongoing.

3. Advertising

Although members need not file research reports with NASD's Advertising Regulation Department, they do constitute "communications with the public" under NASD's advertising rules. As such, NASD's Advertising Regulation Department has conducted two sweeps since NASD Rule 2711 was implemented. In 2002, a sweep of 28 firms was conducted to determine whether firms had made a good faith effort to comply with Rule 2711 and identify any new interpretive issues that might arise. Firms were notified of any compliance shortcomings, with the expectation that those deficiencies promptly would be remedied.

In 2004, NASD's Advertising Regulation Department conducted a second sweep of the ten Global Settlement firms and specifically requested information about their equity research reports (including access to their Web sites), samples of each type of report they used and explanatory material about their ratings. As part of this second sweep, examiners revisited the spot check conducted in 2002 to determine whether firms had made revisions as indicated.

This subsequent review revealed continued deficiencies in several areas. First, some firms were unclear in describing their ratings methodology. For example, some firms failed to explain a two-pronged approach they employed to assess a sector and an individual issuer within that sector. Examiners flagged such reports for failure to comply with the clarity requirement of Rule 2711(h)(10) because the absence of clear ratings descriptions could lead to misconceptions by investors about the firm's actual view of the issuer. Second, some members failed to provide clear disclosure presentations; for example, they used complex systems of footnotes inconsistently and indefinite disclosures (*e.g.*, "may conduct investment banking"). Examiners also identified such practices as violations of Rule 2711's clarity standard. Third, some members failed to use the terms "buy," "hold," and "sell" in the ratings distribution chart, as required by Rule 2711(h)(5). Finally, some members used language that seemed to disclaim responsibility for information in the report about the member firm, including required disclosures of certain conflicts.

NASD's Advertising Regulation Department does not have authority to bring formal actions against members and thus referred to NASD Enforcement those cases where it recommended that further action be considered.

B. NYSE Summary

1. Member Firm Regulation

The NYSE currently has 348 members and member organizations of which 217 are conducting a public business and/or issuing research. The NYSE incorporated the SRO Rule requirements into its exam scope for routine examinations of members and member organizations by Member Firm Regulation ("MFR"), following the effective dates of the SRO Rules in 2002 and 2003.[36]

MFR examiners conducted a series of reviews investigating member and member organization compliance with the SRO Rules and SEC Regulation AC. Between August 2002 and October 2005, MFR conducted a total of 296 examinations.[37] NYSE examiners cited a total of 75 firms with a total of 271 findings for non and/or partial compliance with the SRO Rules and Regulation AC.[38] The findings were distributed as follows: 26 in 2002; 62 in 2003; 152 in 2004; and 31 in 2005.

Specifically, the NYSE examination findings included: (1) failure to clearly and prominently state in research reports in the proper format the disclosures required by the SRO Rules; (2) failure to adhere to the disclosure and record maintenance requirements for associated persons making public appearances; (3) failure to comply with record maintenance requirements evidencing the disclosures in connection with recommendations of securities in print media, interviews, newspaper articles or broadcasts; (4) failure to comply with restrictions on trading activities for associated persons; (5) failure to have legal or compliance personnel intermediate written communications between non-research personnel and research personnel concerning the content of research reports; (6) inclusion of price targets, rating summaries or research ratings information in a draft of a research report sent to a subject company; (7) executing changes to research reports after sending the report to a subject company without proper approval by legal and compliance; (8) allowing research analysts to work under the supervision or control of investment banking department personnel; (9) offering favorable research for business; (10) failure to maintain written procedures for compliance with the SRO Rules; and (11) failure to have a committee in place to review and approve analyst compensation.

2. Enforcement

Between August 2002 and November 2005, 13 examination findings were referred to Enforcement from MFR for SRO Rule violations.[39] As discussed in more detail below, many of

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[36] Only members and member organizations that conducted a public business and/or issued research were examined for compliance with the SRO Rules.

[37] The breakdown of examinations was as follows: 21 firms in 2002, 85 firms in 2003, 140 firms in 2004 and 50 firms in 2005. In many instances the same firm was examined in successive years.

[38] Of the 271 findings, 22 involved Regulation AC. The 22 Regulation AC findings involved: failures by member organizations to maintain clear and prominent disclosures of research analyst certifications; failures to maintain records regarding public appearances of research analysts; failures to specify on the front page of reports the pages on which analyst certifications can be found; failures to have written policies and procedures to prevent inappropriate influences over research analysts; expired or missing certifications; failures with respect to terminated coverage; and missing attestations.

[39] There were also referrals based on findings for Rule 472 prior to its amendment.

these findings are currently the subject of NYSE Enforcement investigation/action, and many have been completed. Recently, a Hearing Panel Decision ("HPD")[40] announced a disciplinary action involving violations of the SRO Rules gatekeeper provisions.[41] This case resulted in consent to censure and a $150,000 fine. Additionally, a member organization has recently consented in a Stipulation of Facts and Consent to Penalty to a fine of $1.5 million in a matter that included, among other things, having a research analyst participate in a road show, and a research analyst giving statements that were not fair and balanced.

There are a number of cases that are now under investigation by NYSE Enforcement. The cases include: research analysts selectively disclosing material non-public information; improper disclosures in research reports; research analysts trading in securities in violation of the SRO Rule blackout prohibitions; research analysts expressing opinions privately about securities they cover that were inconsistent with their published research reports; improper influence of investment banking on research compensation; lack of supervisory analyst qualifications; initiating coverage of a stock during a quiet period; violations of information barrier provisions; violations of the gatekeeper provisions; and books and records violations.

As noted above, there is also an investigation of approximately 30 firms being jointly conducted by the SROs to determine whether firms are in compliance with the requirement to register foreign research analysts who participate in the preparation of member research.

IV. IMPACT OF RULES: ACADEMIC STUDIES AND MEDIA REPORTS

Academic studies and media reports provide both empirical and anecdotal evidence regarding the impact of the SRO Rules,[42] and most have concluded that the rules have helped to address the conflict-of-interest issues that previously compromised the objectivity and reliability of research. Indeed, as the author of one study states:

> [T]he new regulations were successful in their objectives of curbing the excessive optimism driven by the conflicts of interest . . . The distribution of recommendations is now very balanced between buy and sell recommendations . . . and the link between the presence of underwriting business and excess optimism in recommendations was removed.[43]

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40 *See* Exchange HPD 04-136 (NYSE Aug. 11, 2004).

41 The firm was in violation of NYSE Rule 472(b)(4), which prohibits member firms from providing a subject company with draft research reports containing the research summary, rating or price target information.

42 We note that some studies and news articles refer only to the impact of the Global Settlement. Since the key provisions of the Global Settlement closely track those of the SRO Rules, we believe those studies and news articles that address the impact of the settlement terms are a fair proxy for the impact of the SRO Rules.

43 Leonardo Madureira, *Conflicts of Interest, Regulations, and Stock Recommendations*, at 4 (Nov. 2004) (Working paper, Wharton School, University of Pennsylvania) (the "Madureira Study"). *See also, e.g.*, Ohad Kadan, Tzachi Zach & Rong Wang, *Are Analysts Still Biased? The Effect of the Global Settlement and Regulation FD,* Abstract (Mar. 2005) (Working paper, John M. Olin School of Business, Washington

While many other studies and media stories similarly support the effectiveness of the SRO Rules, some contend that the impact has been minimal and that certain conflicts persist. Briefly summarized below are findings and conclusions from a survey of pertinent studies and news articles.

Research Is More Balanced

(a) Changes in ratings distributions

Several academic studies have found that the percentage of buy recommendations decreased and the percentage of sell and hold recommendations increased following adoption of the SRO Rules and Global Settlement. These ratings distribution trends suggest that research analysts are issuing more balanced stock recommendations.

For example, one study found that the percentage of buy recommendations peaked at 74% of all recommendations at the end of the second quarter of 2000 and decreased to 42% of all recommendations at the end of June 2003.[44] During the same period, sell recommendations increased from 2% to 17% of all recommendations, while hold recommendations increased from 24% to 41%.[45]

The Barber Study concludes that "taking a closer look at the trends in 2002 makes clear that [the SRO Rules][46] likely did play a role in analysts' shift away from buy recommendations."[47] Indeed, the study notes that the most pronounced changes in ratings distributions occurred during the weeks leading up to the September 9, 2002 deadline for implementing the ratings distribution disclosure requirement under the SRO Rules.[48] The single biggest change occurred on Sunday, September 8, 2002 when buy recommendations decreased from 57% to 53% and sell recommendations increased from 8% to 11%.[49] Adjusting for certain factors, the authors calculate that there was a greater decrease in the percentage of buys and a greater increase in the percentage of sells and holds following implementation of the SRO Rules than otherwise would have been expected.[50]

University) (the "Kadan Study") ("the Global Settlement was effective in reducing conflicts of interests [sic] between research and investment banking departments in financial services firms").

44 Brad Barber, Reuven Lehavy, Maureen McNichols & Brett Trueman, *Buys, Holds, And Sells: The Distribution Of Investment Banks' Stock Ratings And The Implications For The Profitability Of Analysts' Recommendations*, at 3, 12 (Sept. 2005) (Working paper, Graduate School of Management, University of California, Davis, Ross School of Business, University of Michigan, Graduate School of Business, Stanford University and Anderson Graduate School of Management, University of California, Los Angeles) (the "Barber Study").

45 *Id.*

46 While the authors refer solely to NASD Rule 2711, they state that all conclusions apply to NYSE Rule 472 as well. *Id.* at 1, n.1.

47 *Id.* at 13.

48 *Id.*

49 *Id.* at 13-14.

50 *Id.* at 15.

The Madureira Study found similar results. That study looked at analyst recommendations for the period July 1995 through December 2003 and found that prior to the SRO Rules and Global Settlement, the bulk of consensus recommendations were concentrated in the strong buy and buy categories (accounting for 60% or more of the stocks in the sample) and sell recommendations were "virtually absent."[51] However, from July 2002 through December 2003, "a completely different pattern emerges."[52] For example, in September 2002, the fraction of stocks in the pessimistic category (sell and strong sell) jumped from 3% to approximately 20%.[53] The author found similar patterns with respect to initiation of coverage and ratings upgrades and downgrades, finding that brokerage houses leaned less toward optimistic ratings after the new regulations took effect.[54]

Both the Madureira and Kadan studies found the most decided changes in ratings distributions at firms that maintained or pursued investment banking transactions with covered companies. The Madureira Study found that, prior to the SRO Rules and Global Settlement, the presence of an underwriting business with the subject company implied a 50% increase in the odds that a new recommendation would be optimistic.[55] However, the study found that the effect has "largely disappeared" after the new regulations took effect.[56]

The Kadan Study similarly found that regulatory measures enacted to separate research from investment banking have resulted in less optimistic research by analysts whose firms had or sought investment banking business with companies the analyst covered (an "affiliated" analyst). The study found that prior to the Global Settlement, affiliated analysts generated more optimistic recommendations and long-term growth forecasts than their unaffiliated counterparts; however, those differences have now been eliminated.[57] Consistent with the Barber and Madureira studies, the Kadan Study found a decrease in the percentage of affiliated analysts' buy recommendations and an increase in their hold and sell recommendations following the Global Settlement.[58] The authors found a similar but less dramatic shift in ratings distribution with respect to unaffiliated analyst recommendations.[59]

In a subsequent paper combining the Madureira and Kadan studies, the authors explained that analysts changed their behavior in an asymmetric way after adoption of the SRO Rules.[60]

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51 Madureira Study at 17-18.

52 *Id.* at 18.

53 *Id.*

54 *Id.* at 21.

55 *Id.* at 4.

56 *Id.*

57 Kadan Study at 4, 26.

58 *Id.* at 21-22, Table 6.

59 *Id.* at 22.

60 Ohad Kadan, Leonardo Madureira, Rong Wang & Tzachi Zach, *Conflicts of Interest and Stock Recommendations - The Effects of the Global Settlement and Recent Regulations*, at 25 (July 2005) (Working paper, John M. Olin School of Business, Washington University and Weatherhead School of Management, Case Western Reserve University).

Analysts now behave similarly when deciding whether to post an optimistic recommendation, and the likelihood of receiving an optimistic recommendation no longer depends on whether the analyst's firm participated in an equity offering for the subject company.[61] However, affiliated analysts are still reluctant to issue pessimistic recommendations for companies that have had a recent equity offering.[62]

One recent academic study found lesser changes in ratings distributions since the Global Settlement.[63] The author analyzed data for each of the ten Global Settlement firms and found that prior to the settlement, between 28.4% (in 2002) to 39.8% (in 2000) of recommendations across the ten firms carried a firm's highest rating. After the settlement, top recommendations comprised between 31.8% (in 2003) and 39% (in 2004) of all recommendations.[64] The percentage of the most negative recommendations decrease from a pre-settlement range of 24.1% (in 2000) to 32.4% (in 2002) to a post-settlement range of 18.8% (in 2003) and 12.8% (in 2004).[65] The author notes that the numbers may be explained by factors other than bias, such as analysts' accurate and unbiased expectation of investment value in the post-settlement period or the fact that analysts may intentionally have skewed their coverage post-settlement to stocks that they expect will outperform the market.[66]

A number of news articles buttress the conclusion that sell-side analysts are less biased after implementation of the SRO Rules and/or the Global Settlement and now are more prone to issue downgrades and sell recommendations. According to a recent article, "sell-side analysts do appear to be more discerning," noting that sell ratings, which accounted for less than 2% of the ratings published on Wall Street in 2002, were up to between 10% and 15% of the ratings at all major brokerages.[67] Another article reported in August 2003 that sell recommendations represented 15-25% of overall opinions, attributing the trend at least in part to adoption of the SRO Rules.[68] According to *The Wall Street Journal*, at one point in 2000, 95% of the stocks in the S&P 500 had no sells at all and no stock had more than one sell rating; today, only 38% are without sell recommendations, 62% have at least one sell and 9% have five sells or more.[69]

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61 *Id.*

62 *Id.* at 25-26.

63 Leslie Boni, *Analyzing the Analysts After the Global Settlement*, at 5 (Aug. 25, 2005) (Working paper, University of New Mexico) (the "Boni Study").

64 *Id.* at 13.

65 *Id*.

66 *Id.* at 14.

67 Nat Worden, *Mixed Returns on Spitzer Research Settlement*, The Street.com, Apr. 22, 2005, http://www.thestreet.com/markets/natworden/10218183.html. *See also* Dan Ackman, *Wall Street Tries To Say 'Sell'*, Forbes.com, June 20, 2003, http://www.forbes.com/2003/06/20/cx_da_0620topnews_print.html (in June 2003, 43% of recommendations were buy, 46.6% were hold and 10.5% were sell, compared with June 2000, when 74.6% of all recommendations were buy and only 0.7% were sell); *Facts Without Fiction,* Crystal Research Assoc., LLC, Issue 3 (Winter 2005); *Analysts Say 'Sell' A Lot More Often*, Reuters News Service, May 18, 2003, http://www.chron.com/disp/story.mpl/business/mym/1914061.html.

68 Andrew Leckey, *Dumping Stock Shouldn't Be Such A Hard Sell*, Chicago Tribune, Aug. 12, 2003, at C4.

69 E.S. Browning, *Analysts Keep Misfiring With 'Sell' Ratings*, Wall St. J., Apr. 11, 2005, at C1.

Some news stories also report that bias still exists, particularly at larger firms with investment banking businesses.[70] According to one report, the top ten Wall Street firms give a higher percentage of buy ratings – 46% versus 40% – to those companies with which they do investment banking business.[71] Another article reports that many firms still maintain only 0-6% sell recommendations.[72] Finally, one news article reports that small firms may be slightly more likely to issue buy recommendations than the Global Settlement firms.[73]

(b) Correlation between recommendations and earnings forecasts

A recent academic study attempted to measure research bias after the SRO Rules by examining the relationship between earnings forecasts and recommendation profitability across three groups of sell-side analysts: "top-tier" analysts at the top investment banks, other investment bank analysts and non-investment bank analysts.[74] Absent bias, the authors believe that there should be a strong correlation between accuracy in predicting earnings and profiting from following analyst recommendations since most recommendations are derived from earnings analysis. The authors further posit that bias is more likely to appear in recommendations than earnings forecasts because analysts' reputations are tied more closely to accurately predicting earnings.

During the 1993 to 2000 period, the study found a "positive and significant association" between forecast accuracy and recommendation profitability for non-investment bank analysts, but no such relation for top-tier analysts and other investment bank analysts.[75] The authors suggest that this finding demonstrates that before the SRO Rules, the presence of conflicts at investment banks resulted in overly optimistic recommendations disconnected from earnings forecasts.[76] However, in the period following the Global Settlement and implementation of the SRO Rules, the study found such positive correlation between earnings forecast accuracy and recommendation profitability for analysts employed by top-tier investment banks, suggesting that "the increased awareness of the conflicts of interest and the regulatory changes might have had their desired effect."[77]

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70 *See, e.g.,* Amey Stone, *Yes, Wall Street Research Is Better*, BusinessWeek Online, June 28, 2004, http://businessweek.com/bwdaily/dnflash/jun2004/nf20040628_1253_db014.htm ("some might conclude that bias still exists").

71 *Id*.

72 Joseph McCafferty, *Reform of Sell-side Research is Creating A Variety of New Headaches for Corporations*, CFO Magazine, May 2003. *See also* Leckey, *supra* note 68.

73 Susanne Craig, *Research Rules Trickle Down To Small Firms*, Wall St. J. Online, Jan. 18, 2004, http://online.wsj.com/article/o,,SB107446466140004574,00.html.

74 Yonca Ertimur, Jayanthi Sunder & Shyam V. Sunder, *Measure for Measure: An Examination of the Association between Forecast Accuracy and Recommendation Profitability of Sell-Side Analyst* (Mar. 2005) (Working paper, Graduate School of Business, Stanford University and Kellogg School of Management, Northwestern University) (the "Ertimur Study").

75 *Id.* at 4.

76 *Id.* at 2.

77 *Id*. at 19.

Research Is More Reliable, Accurate And Informative For Investors

Recent studies and a number of news articles suggest that the quality of research and value to investors has improved since adoption of the SRO Rules. For example, one article reports that the "most important change for the better is in the quality of analysis . . . written commentary in stock reports is more independent, more thought-provoking, and better represents the upside and downside potential for a stock than the bubble era's much-hyped reports."[78] And in numerous interviews, portfolio managers attest to the improvement.[79] Another article reports that "the investment community is now benefiting from more diverse research strategies, with access to reports that are less restricted and more user-friendly."[80] As discussed in more detail below, research has also become more trusted by the market and more reliable and meaningful for investors.

(a) Ratings reflect their plain meanings

The SRO Rules require that ratings be consistent with their plain meanings, and several studies have concluded that ratings indeed are now truer and therefore more predictive for investors. For example, the Kadan Study found that following the Global Settlement, the price reaction in the market to buy recommendations has been "significantly more positive" and the price reaction to hold recommendations has been "significantly less negative."[81] In other words, the market now accepts ratings at face value and stocks trade consistent with the plain meanings of the recommendations. According to the Kadan Study, these results suggest that buy and hold recommendations are now "more informative to investors."[82] As for sell recommendations, the Kadan Study found more mixed results.[83] The Madureira Study also found that firms now generally seem to "mean what they say" when issuing hold and sell recommendations,[84] concluding that "brokerage houses no longer are disguising pessimistic recommendations as neutral ratings."[85] In contrast, before the SRO Rules and Global Settlement, a hold rating often was tantamount to a sell recommendation,[86] which would generate far greater negative price reaction in the market than the author has found since implementation of the regulations.

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78 Stone, *supra* note 70 (in the "bad old days," research on the same company was "often barely distinguishable" among research firms).

79 *Id. See also* McCafferty, *supra* note 72 (most experts expect analysts to "dig deeper into the companies they cover").

80 *Facts Without Fiction*, *supra* note 67, at 1 (noting that research is now "a competitive marketplace of versatile and diverse research providers"). *See also SIA Research Management Conference: Reflections on Two Years Since the Global Settlement*, SIA Research Reports, Vol. VI, No. 9 (Sept. 30, 2005) ("panelists agreed that there is a far greater variety of research products and services available today").

81 Kadan Study at 20.

82 *Id.*

83 *Id.*

84 Madureira Study at 3, 25-26.

85 *Id.* at 25, 26. The study did, however, find some negative market reactions to hold recommendations issued by non-settling firms.

86 Madureira Study at 2.

However, one recent academic study has found that investors are less responsive to analyst recommendations. The Boni Study found that market participants on average respond less to recommendation changes made by the ten settlement firms after the Global Settlement (*i.e.*, stock prices increase less on upgrades and decrease less on downgrades than they did prior to the Global Settlement).[87] The author notes that it is possible that retail investors react to analyst recommendations as they did before the settlement but institutional investors respond less.[88]

(b) Recommendations may be more accurate and predictive of investment profitability

Reports suggest that research has become more accurate following implementation of the SRO Rules and the Global Settlement, which served "as a wake-up call for many sell-side research professionals . . . . As a result, broker/dealers and investment banks are now paying much more attention to the accuracy of their research recommendations."[89]

And there is evidence that investors who follow recommendations may be seeing improved returns. For example, the Barber Study concluded that the disclosure requirements in the SRO Rules provide investors with helpful information to assess the value of a research analyst's recommendation and to predict profitability by investing consistent with those recommendations. The authors found that prior to the implementation of the SRO Rules, upgrades from brokers with the highest percentage of pessimistic ratings outperformed by an average of 50 basis points those brokers that tended to have a more optimistic ratings distribution.[90] The obverse also held true: downgrades to hold or sell from the more optimistic brokers significantly outperformed investments in stocks downgraded by brokers with more pessimistic ratings distributions.[91] The authors note that these differences have effectively evaporated after implementation of the SRO Rules, leading to their conclusion that the ratings distribution disclosure requirement has made research more transparent for investors.[92]

According to Starmine, a firm that rates analyst performance, following analysts' advice would have had a slightly negative impact on portfolios on average in 2002; however, in 2003, it would have added 2.2 percentage points to returns.[93] In 2004, analysts outperformed benchmarks by

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87 Boni Study at 19.

88 *Id*. However, this seems inconsistent with the author's observation that according to polls, most institutional investors said that they largely ignored analysts' recommendation ratings prior to the Global Settlement. *Id.* at 3.

89 Integrity Research Assoc. & Meghan Leerskov, *Gauging The Independent Edge*, Buyside, June 2004, at 61, 66. *See also* Stone, *supra* note 70 (quoting a senior analyst at First Call as saying that research over the prior two years "has become more objective, more original, and more accurate").

90 Barber Study at 6, 31.

91 *Id*.

92 *Id. at 36.*

93 Stone, *supra* note 70. *See also* Daniel Gross, *The Best Stock Tips in Town - Buy When These Guys Say Buy, Not When Those Guys Say Buy*, Aug. 4, 2004, http://slate.msn.com/id/2104760 (according to a Smith Barney study, investors who heeded consensus advice from mid-2001 through mid-2003 would have lost money, including a loss of more than 35% in the fourth quarter of 2001; however, there were two straight

1.3 percentage points.[94] In addition, by 2005, five of the top ten best-performing research shops were sell-side brokerages, as opposed to two years ago, when independent analysts occupied nine of the top ten spots.[95]

On the other hand, the Boni Study found very little change in the performance of analyst recommendations. The Boni Study found that stocks that received the strongest recommendations of settling firm analysts outperformed the S&P 500 index both before and after the Global Settlement.[96] The study found the same to be true for stocks that received the analysts' worst ratings and in fact, more often than not, such stocks outperformed those stocks that received analysts' strongest recommendations both before and after the Global Settlement.[97] In discussing these findings, the author noted that both before and after the Global Settlement, recommended stocks that outperformed the S&P 500 index did so at least in part because they are riskier investments on average.[98]

Some news reports also have suggested that the accuracy of research has not improved appreciably as a result of the SRO Rules. An analysis performed for *The Wall Street Journal* indicates that analysts are doing no better a job of picking stocks than they were before the research scandals.[99] The article reported that since 2000, "even though Wall Street supposedly has become more discriminating," stocks with large proportions of sell ratings are performing better than those with buy and hold ratings.[100] In 2003-2004, stocks with the most sell ratings rose 36% on average, while those with the most buys rose just over 25%.[101]

Research Ratings Have Been Simplified

The SRO Rules also have led to widespread adoption of simplified ratings systems. As the Madureira Study explained, the new ratings systems are simplified in terms of the number of ratings categories and the meaning among analysts is "very uniform."[102] Eight of the ten Global Settlement firms adopted new ratings system in 2002, and many of the next largest brokerage

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quarters of positive performance in the second half of 2003); Melissa Lee & John Metaxas, *Change Comes Slowly To Wall St. Research*, Apr. 26, 2004, http://msnbc.msn.com/id/4816690/print/1/displaymode/1098.

94 Matt Krantz, *Analysts Deliver Better Advice*, Feb. 9, 2005, http://www.investars.com/articles20050209.asp; Jane J. Kim, *Stock Research Gets More Reliable*, Wall St. J., June 7, 2005, at D1.

95 Worden, *supra* note 67. *See also* Kim, *supra* note 94 (some of the brokerage firms that were part of the Global Settlement have climbed higher in rankings of the best-performing research shops).

96 Boni Study at 5.

97 *Id.*

98 *Id.* at 5-6.

99 Browning, *supra* note 69.

100 *Id.*

101 *Id.*

102 Madureira Study at 13. The author noted that the changes in ratings systems came about in response to the SRO Rules, which "express[ed] the regulators' concern about ratings systems that were loosely defined and perhaps not properly understood by the research's clients." *Id.* at 11.

houses began to adopt new systems around the same time.[103] Only one of the new ratings systems was adopted before the SRO Rules became effective in July 2002, and many came on line contemporaneous with the September 9, 2002 implementation date of the SRO Rules ratings distribution requirements.[104] Most large brokerage houses now use a three-tier ratings system, and every new ratings system adopted after 2001 is a three-tier system.[105]

Some news articles indicate that research can still be confusing for investors, since not all brokerages have adopted new ratings systems, and there is no mandated or accepted uniform ratings system for those that have them.[106]

Conflicts Of Interest Have Been Reduced But Not Eliminated

Numerous articles provide anecdotal evidence that the conflicts of interest arising from the close relationship of research and investment banking have been mitigated following implementation of the SRO Rules and Global Settlement. For example, one investment bank had to drop out of a large IPO in May 2005 after its top media research analyst told the firm's senior bankers that they were overpricing the shares.[107] In another example, analysts at two firms that launched a recent hot IPO began coverage on the stock with an "underperform" rating.[108]

However, a December 2004 *Newsweek* article reports that despite the regulatory changes and Global Settlement, the "big financial firms are still rife with conflicts that put their own interests, and those of big banking clients, ahead of everyone else's."[109] The article cites as evidence of such conflicts the fact that analysts can still meet with executives around the time they are considering which investment bankers to hire and investment banking fees continue to flow into a pool of money used to pay analysts.[110] Another article reports that "at some firms, banking and research were still a little too cozy" and companies looking for underwriters "still want to be sure they'll get positive research coverage once their stock is issued."[111] According to the article,

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103 *Id.* at 11.

104 *Id.* at 13; *see also* Barber Study at 14.

105 Madureira at 13. The result of the change in ratings system was that many outstanding recommendations were downgraded. *Id.* at 14. More than 90% of the stocks newly rated pessimistic were rated at least neutral under the old system, and more than 40% of the stocks newly rated neutral were rated at least buy/strong buy under the old system. *Id.*

106 Susanne Craig & Ann Davis, *Analyze This: Research Is Fuzzier Than Ever*, Wall St. J., Apr. 26, 2004 at C1 (ratings are not comparable across firms because the SRO rules do not require a uniform methodology).

107 Andrew Ross Sorkin & Jeff Leeds, *Has Wall Street Changed Its Tune?*, June 19, 2005, http://boycott-riaa.com/article/17252 (stating that "[t]hroughout Wall Street, research analysts at major investment banks are increasingly showing a new sense of independence"). *See also* Joseph Nocera, *Wall Street on the Run*, June 14, 2004, http://www.pbs.org/wsw/news/fortunearticle_20040614_02.html (reporting that there have been "plenty of stories about analysts, freed from pressure from bankers, who vetoed important underwriting deals").

108 Matt Krantz, *IPO underwriters' ratings get tougher, Baidu.com hit*, USA Today, Sept. 14, 2005.

109 Charles Gasparino, *The Street's Dark Side*, Newsweek (U.S. Edition), Dec. 20, 2004, at 40.

110 *Id.*

111 Nocera, *supra* note 107.

research continues to be used to attract banking business.[112] Another article suggests that "change has come more slowly to smaller securities firms."[113] The article tells the story of one analyst who, after adoption of the SRO Rules, received a voice mail from a banker scolding him for a negative report and threatening that the analyst's compensation is still determined by investment banking revenue.[114]

A Harvard Business School professor who has studied research analysts said in an interview that even where research is separated from investment banking, conflicts of interest persist.[115] These conflicts arise because (1) sell-side analysts have incentives to hype stocks to generate trading business through large institutional investors who may be clients of the brokerage firm, and (2) once a sell-side analyst has prompted an institutional client to take a large position in a stock recommended by the analyst, the analyst faces a disincentive to downgrade the stock and thereby impact the value of the client's position.[116]

In addition, while the SRO Rules may have lessened the internal pressure on analysts, there have been a number of reports indicating that analysts are coming under external pressure – retaliation by issuers against analysts who have downgraded their stock.[117] Some say that the regulatory reforms splitting investment banking from stock research could shift the source of pressures from investment banking to the issuers.[118]

Research Coverage Has Diminished

Several press accounts report that the number of companies covered by research analysts has decreased since the implementation of the Global Settlement and SRO Rules. A recent report says that since 2002, 691 companies have lost analyst coverage altogether and 99% of the

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112 *Id. See also Timing of Stock Issuance Raises Eyebrows After Upgrade*, Wall St. J., Sept. 14, 2005, at C1 (within two days after research analyst upgraded stock, employing firm won the right to lead a stock issue for the company).

113 Craig, *supra* note 73.

114 *Id.*

115 Ann Cullen, *The Bias of Wall Street Analysts*, Oct. 18, 2004, http://hbswk.hbs.edu/tools/print_item.jhtml?id=4430&t=enterpreneurship.

116 *Id.*

117 Gretchen Morgenson, *You'll Never Do Research in This Town Again*, N.Y. Times, July 31, 2005, at BU 1 (fear of retaliation from the companies they follow may explain analysts' unreasoned optimism); Adrienne Baker, *Leader: Spitzer's Next Challlenge?* Apr. 2005, http://ironthenet.com/feature.asp?current=1&articleID=4048 (in a survey of 732 analysts, 40% said they felt shut out by a firm after they downgraded its equity and another 6% said that companies had threatened to suspend banking relationships following a downgrade); Melissa Lee & John Metexas, *When Companies Behave Badly To Analysts*, Apr. 29, 2004, http://msnbc.msn.com/id/4816980/print/1/displaymode/1098/; Richard J. Wayman, *Are Analysts 'Too' Independent? Apparently The French Think So*, Jan. 30, 2004, http://www.researchstock.com/cgi-bin/rview.cgi?c=bulls&rsrc=RC-20040130-F; Deborah Solomon & Robert Frank, *'You Don't Like Our Stock? You Are Off The List'*, Wall St. J., June 19, 2003, at C1; *Corporate Retaliation on Analysts*, Apr. 8, 2003, http://www.ironthenet.com/static/disclosure/USCanada/CorporateRetaliation0403.htm.

118 Solomon & Frank, *supra* note 117.

companies that have lost coverage are smaller companies with a stock market value of less than $1 billion.[119] According to Reuters Research, as of January 2004, 666 companies in its database of 4,075 had been "orphaned" by sell-side analysts, while in 2002, only 85 companies were left without analyst coverage.[120] Of the companies that have not been orphaned, 380 are down to a pair of analysts, while 473 companies have just one.[121] Similarly, a recent academic study has found that the number of stocks covered by the ten Global Settlement firms has dropped an average of 14% relative to 2000 and 20% relative to 2001.[122] However, three of the ten firms show little change or even an increase in the number of companies they covered pre- and post-settlement.[123]

On the other hand, at least one article indicates that there has been no loss in coverage. In June 2004, First Call, which monitors and distributes analysts' reports, said that as much research coverage is being generated and that 4,158 companies were being covered, down from 4,257 in June 2002.[124]

To the extent that coverage has diminished, some of the cutback has been attributed to the new regulatory environment, while others say that it is not clear that the new regulations are wholly to blame,[125] and some blame "long-term economic forces."[126]

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[119] Susanne Craig, *Firm To Research Stock 'Orphans'*, Wall St. J., June 7, 2005, at C3. *See also* SIA Research Reports, Vol. VI, No. 9, at 12 ("Panelists also agreed that there appears to be a decline in the coverage of smaller stocks (those with market capitalization lower than $1 billion), which has a negative impact on capital formation."); Robert Scott Martin, *Issuer-Paid Research Comes of Age*, Buyside (2005), http://www.buyside.com/archives/2005/0501/0501fidea.asp (64% of all publicly traded companies do not have sell-side coverage and if over-the-counter stocks are included, the number jumps to 80%); Ritu Kalra, *Paid-For Research Scores With Investors*, Reuters, July 17, 2004, http://www.boston.com/business/articles/2004/07/17/paid_for_research_scores_with_investors/ (for companies whose market capitalization is less than $500 million, overall coverage is down by more than 35% since 2001 and nearly 60% of all publicly traded companies in the U.S. get no coverage at all); Lee & Metaxas, *supra* note 93 (Morgan Stanley cut stocks covered in North America by 26% and Merrill by 30%); Landon Thomas Jr., *Changed Smith Barney Is Thin on Analysts*, N.Y. Times, June 13, 2003, at C1 (Smith Barney discontinued coverage – at least temporarily – of close to 250 companies); McCafferty, *supra* note 72 (in 1998, 6,100 companies drew coverage from at least one analyst, but by May 2003, that number was down 30%, to 4,300).

[120] Marie Leone, *The Flight of The Sell-Side Analyst*, July 8, 2004, http://www.cfo.com/printable/article.cfm/3015019?f=options.

[121] *Id.*

[122] Boni Study at 4.

[123] *Id.* at 12.

[124] Stone, *supra* note 70 (noting that this decline may reflect the absence of IPOs and merger activity rather than research changes).

[125] Rachel McTague, *Goldschmid Concerned About Reduction In Broker-Dealers' Budgets For Research*, BNA, Inc., Sept. 21, 2004.

[126] Martin, *supra* note 119.

Research Industry Has Changed

There have been many reports that the "old research model is dead,"[127] although little consensus has emerged as to the new models. Summarized below are some additional reported changes in the research industry, not discussed elsewhere in this section, since the implementation of the SRO Rules and Global Settlement.

- Institutional investors are diverting equity commission dollars away from Wall Street's traditional research to securing access to analysts and company management.[128]

- There has been a decrease in sell-side research staff and budgets in light of the separation of research from investment banking revenue.[129]

- Sell-side analysts are migrating to the buy-side/money management firms.[130]

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127 Nocera, *supra* note 107. *See also* Kyle L. Brandon, *Update on Research Analysts Related Issues*, SIA Research Reports, Vol. VI, No. 5, at 8 (May 27, 2005) (to date, "sell-side firms have not come up with an answer to the question 'what is the new business model after the global settlement?'").

128 James Langton, *Study Shows Institutions Moving Away From Wall St. Research*, July 13, 2005, http://www.investmentexecutive.com/client/en/News/ImprimerDetail.asp?Id=29645&IdSe.

129 SIA Research Reports, Vol. VI, No. 9, at 11 (one panelist estimated that research lost half of its funding with the loss of investment banking revenues at the same time that commission revenue fell by 30%); Mara Der Hovanesian & Amy Borrus, *Can The Street Make Research Pay? In The Eliot Spitzer Era, It's Looking More and More Like An Expensive Luxury*, Jan. 31, 2005, http://www.capco.com/print.aspx?page=%2fpress.aspx%3fid%3d536 (research budgets at the seven biggest U.S. securities firms have fallen by more than 40% since 2000); McTague, *supra* note 125 (research budgets are down by as much as one-third at some broker-dealer firms); Leone, *supra* note 120 (the number of sell-side analysts has decreased by 15-20% over the last few years); Adam Piore, *Can Investors Get An Honest Stock Tip On (Or Off) Wall Street?*, Newsweek Int'l, Mar. 2004, http://www.msnbc.msn.com/id/4468645 (HSBC announced that it would stop picking stocks altogether, declaring the old research model "broken"); Ann Davis, *Increasingly, Stock Research Serves The Pros, Not 'Little Guy'*, Wall St. J., Mar. 5, 2004, at A1; Daniel Dunaief, *Analysts Abandon Wall St*., N.Y. Daily News, Feb. 24, 2003, http://www.nydailynews.com/business/v-pfriendly/story/61941p-57842c.html (analysts are leaving Wall Street and research has become more bureaucratic in light of new regulations).

130 Greg Crawford, *Money Managers Beefing Up Their Research Staffs; Search For New Ideas Spurs Firms Into Action*, Investment News, June 20, 2005, at 15 (money managers are beefing up their research staffs and between early 2003 and early 2005, the average research staff at U.S. buy-side institutions increased from 9.3 to 10.5 people); Bill Slocum, *Is There A Future For Wall Street Research?*, June 27, 2003, http://www.researchstock.com/cgi-bin/rview.cgi?c=outside&rsrc=RA-20030627-F (in-house equity analysts are being asked to cover more industries and companies than ever before); *Sell Side Gets A Boost*, June 23, 2003, http://www.ironthenet.com/newsarticle.asp?current=1&articleID=2761 (reporting on the increased pressure on buy-side analysts to cover more industries); Paula Lace, *Sell-Side Analysts Make A Break For The Buy Side*, TheStreet.com, Mar. 5, 2003, http://www.thestreet.com/markets/paulalace/10072239.html (the shift to the buy-side could result in making the research industry "even more clubby").

- Many companies are outsourcing research staff to foreign countries, such as India.[131]

- Research is not going to the small investor, whom the regulations were designed to protect, but to institutional investors.[132]

- Issuer-paid research is on the rise as a result of the loss of coverage.[133]

V. REVIEW OF RULE PROVISIONS

A. Analytical Framework for Review

The SRO staffs have conducted a section-by-section review of the SRO Rules to determine whether any additions, deletions or amendments are warranted. In evaluating each provision, the SRO staffs have been guided by several analytical touchstones. First, the SRO staffs looked to the principles that underpinned the original rule development to see if a provision is accomplishing its intended purpose. Second, the SRO staffs reviewed findings from examinations, sweeps and enforcement actions. Third, the SRO staffs considered interpretive requests and member questions. Fourth, the SRO staffs compared the rules to the provisions of the Global Settlement. Fifth, the SRO staffs considered potential gaps or overbreadth in the existing rules. Finally, the SRO staffs considered suggestions from industry groups and members.

B. Section-by-Section Review

Set out below is a discussion of those provisions for which the SRO staffs recommend amendments or further interpretation to the rules. The SRO staffs believe that the other provisions of the SRO Rules are operating effectively and efficiently in achieving their purpose,

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131 Der Hovanesian & Borrus, *supra* note 129; Davis, *supra* note 129; Khozem Merchant & David Wells, *Banks Move Analysts' Work To India*, Financial Times (London), Aug. 20, 2003, at 1.

132 Davis, *supra* note 129 ("the most pioneering, market-moving research is going exclusively to big mutual funds and the private investment pools knows as hedge funds").

133 SIA Research Reports, Vol. VI, No. 9, at 12 (summarizing panel discussion on the issue of "made-to-order" research tailored to meet client requests); Martin, *supra* note 119 (paid-for researchers "have taken strict measures to keep their work as independent as humanly possible"); Kalra, *supra* note 119 (portfolio managers are overcoming their skepticism of issuer-paid research, citing impressive performance and access to information on companies large Wall Street investment banks do not cover); Melissa Lee & John Metaxas, *Beware of Wall St. 'Research For Hire'*, Apr. 28, 2004, http://www.msnbc.msn.com/id/4816907/print/1/displaymode/1098/ (current regulations are not strong enough to protect investors vis-à-vis research for hire and if an analyst is not associated with a broker-dealer, perhaps "caveat emptor" should apply); Ann Davis, *Wall Street, Companies It Covers, Agree on Honesty Policy*, Wall St. J., Mar. 11, 2004, at C1 (discussing best practices guidelines that were a joint effort between the Association for Investment Management and Research and the National Investor Relations Institute); Lynn Cowan, *Research-For-Hire Shops Growing, Seeking Legitimacy*, Wall St. J. Online, July 7, 2003, http://online.wsj.com/article_print/0,,BT_CO_20030707_001632,00.html; Thomas S. Mulligan, *Ignored by Wall St., Firms Turn To Research-For-Hire Outfits; As The Fee-Based Industry Tries To Fill The Gap Left By The Withdrawal of Analyst Coverage, Some Experts Have Reservations*, Los Angeles Times, June 3, 2003; McCafferty, *supra* note 72.

and therefore no changes are recommend to those provisions at this time. In making the recommendations, the SRO staffs are mindful that consideration must be given to the mandates of Sarbanes-Oxley and that, in certain instances, implementing the recommendation may require an exemption from the SEC. The SRO staffs did not attempt to address every interpretive issue that may be outstanding and will continue to entertain interpretive requests on a case-by-case basis and to publish, as warranted, additional joint memoranda setting forth key interpretations.

1. Definitions

Current Rules

The SRO Rules currently include the following defined terms:

<u>"Public appearance"</u> means any participation in a seminar, forum (including an interactive electronic forum), radio, television or print media interview, or other public speaking activity, or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

<u>"Research report"</u> means a written or 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.

<u>"Research analyst"</u> means the associated person who is primarily responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of "research analyst."

Recommended Changes

The SRO staffs recommend several changes to the definitions in NASD Rule 2711 and NYSE Rule 472 to make certain interpretations express in the rule language and to circumscribe the scope of communications subject to the SRO Rules.

<u>"Public Appearance"</u>

The SRO staffs recommend amending the definition of "public appearance" to codify an interpretation consistent with SEC Regulation AC that the term applies only to appearances involving 15 or more separate investors. The SRO staffs further recommend that the definition also codify an exception to that interpretation contained in NASD *Notice to Members* 04-18 and NYSE Information Memo 04-10: that it excludes password-protected Webcasts, conference calls and similar events with 15 or more existing customers, provided that the participants previously received the most current research report or other documentation that includes the disclosures required by the SRO Rules and that the research analyst making the appearance corrects or updates any disclosures that are inaccurate, misleading or no longer applicable.

<u>"Research Report"</u>

The SRO staffs recommend several amendments to the definition of "research report."

First, the SRO staffs suggest codifying the various exceptions to the definition set forth in the two joint interpretive memoranda.[134] These exceptions essentially parallel those in SEC Regulation AC and the Global Settlement and are set forth below:

- reports discussing broad-based indices, such as the Russell 2000 or S&P 500 index;
- reports commenting on economic, political or market (including trading) conditions;
- technical or quantitative analysis concerning the demand and supply for a sector, index or industry based solely on trading volume and price;
- reports that recommend increasing or decreasing holdings in particular industries or sectors or types of securities;
- statistical summaries of multiple companies' financial data and broad-based summaries or listings of recommendations or ratings contained in previously-issued research reports, provided that such summaries or listings do not include any narrative discussion or analysis of individual companies; and
- notices of ratings or price target changes that do not contain any narrative discussion or analysis of the subject company, provided that the member simultaneously directs the readers of the notice as to where to obtain the most recent research report on the subject company that includes the disclosures required by the rule, and the notice does not refer to a research report that contains materially misleading disclosure, such as where the disclosures are outdated or no longer applicable.

In addition, the SRO staffs recommend codifying two other exceptions to the definition of "research report" contained in the March 2004 Joint Memorandum and SEC Regulation AC. These exceptions exclude certain communications even if they include information reasonably sufficient upon which to base an investment decision or a recommendation or rating of individual securities or companies:

- any communication delivered to fewer than 15 persons; and
- periodic reports, solicitations or other communications prepared for current or prospective investment company shareholders (or similar beneficial owners of trusts and limited partnerships) or discretionary investment account clients that discuss individual securities, provided that such communications discuss past performance or the basis for previously made discretionary investment decisions.

Second, the SRO staffs recommend explicitly excluding from the definition sales material regarding registered investment companies and direct participation programs ("DPPs"). Since investment companies and DPPs are "equity securities" as defined in Section 3(a)(11) of the Securities Exchange Act of 1934, related sales material that contains an analysis of those

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134 *See* NASD *Notices to Members* 02-39 (July 2002) and 04-18 (Mar. 2004) and NYSE Information Memos 02-26 (June 26, 2002) and 04-10 (Mar. 9, 2004).

securities and information sufficient upon which to base an investment decision technically is covered by the definition. Yet sales material regarding investment companies is already subject to a separate regulatory regime, including NASD Rule 2210, NYSE Rule 472 and SEC Rule 482, and all advertisements and sales literature regarding investment companies and DPPs must be filed with the NASD Advertising Regulation Department. Moreover, the SRO staffs do not believe that the conflicts underpinning the SRO Rules are manifest to the same extent with respect to research on investment companies and DPPs.

Third, the SRO staffs recommend codifying a longstanding interpretation that communications that constitute prospectuses under the Securities Act of 1933, including free-writing prospectuses as defined under the SEC's recent Securities Offering Reform rules,[135] are not considered "research reports," even if they meet the definitional elements. Such prospectuses facilitate differing purposes from research reports and are subject to a separate comprehensive regulatory scheme.

<u>"Research Analyst"</u>

Several industry members have urged the SROs to amend the definition of "research analyst" to exclude any member personnel who are not principally engaged in the preparation or publication of research reports – a limitation contained in the Global Settlement. The SRO Rules, in accordance with the mandates of Sarbanes-Oxley, are constructed such that the author of a communication that meets the definition of a "research report" is a "research analyst," irrespective of his or her title or primary job. This prevents firms from circumventing the rules by redirecting through other channels, such as registered representatives or traders, potentially biased research that is not subject to the SRO objectivity safeguards.

The SRO staffs believe it is important to maintain such communications as research reports subject to the rules and those principally responsible for their preparation as research analysts. However, the SRO staffs recommend consideration of a limited exemption from the registration requirements for non-research personnel that produce research reports. The SRO staffs believe that the registration and qualification requirements were intended for those individuals whose principal job function is to produce research, while the balance of the SRO Rules are intended to foster objective analysis of equity securities and transparency of certain conflicts and to provide beneficial information to investors.

2. Restrictions on Investment Banking Department Relationship with Research Department

Current Rules

The SRO Rules permit investment banking and other non-research employees, other than legal and compliance personnel, to review a research report before publication only to verify the factual accuracy of information in the report or identify a potential conflict of interest. The rules further require that an authorized legal or compliance official act as intermediary for all such permissible communications.

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[135] Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005), 70 FR 44722 (Aug. 3, 2005).

Recommended Changes

The SRO staffs recommend eliminating the provision that permits pre-publication review of research by investment banking and other non-research personnel, other than by legal and compliance. The SRO staffs believe that review of facts in a report by investment banking personnel is unnecessary in light of the numerous other sources available to verify factual information and only raises concerns about the objectivity of the report. Such review may invite pressure on a research analyst from investment banking personnel that could be difficult to monitor.[136]

The SRO staffs note that such factual review is not permitted under the terms of the Global Settlement. Moreover, legal and compliance can adequately perform a conflict review without sharing draft research reports with investment banking personnel.

3. Restrictions on Solicitation of Investment Banking Business

Current Rules

The SRO Rules prohibit research analysts from participating in efforts to solicit investment banking business, including pitch meetings with prospective clients.

Recommended Changes

This provision, which mirrors language in the Global Settlement, strikes at a core conflict that can compromise research analysts' objectivity when they and their research are utilized to win business rather than provide dispassioned analysis. While the SRO staffs believe this provision is operating effectively, some members have asked for additional guidance regarding references to research analysts and research in pitch books and related meetings. The SRO staffs note that the SEC has provided interpretive guidance to the parallel provisions of the Global Settlement and concluded that it would be inconsistent with the purpose of the solicitation ban to include in a pitch book or related presentation materials any information regarding an analyst employed by a firm or an analyst's views. The SRO staffs generally agree with that guidance and intend to address this area in more detail in a future interpretive memorandum.

4. Restrictions on Sales and Marketing Activities

Current Rules

The SRO Rules prohibit research analysts from participating in road shows related to investment banking services transactions and from engaging in any communications regarding investment banking services transactions with current or prospective customers in the presence of investment banking personnel or company management. Investment banking personnel also are prohibited from directing a research analyst to engage in sales or marketing efforts or to engage in any communication with a current or prospective customer related to investment banking transactions.

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[136] *See, e.g.*, Craig, *supra* note 73.

Recommended Changes

This provision, which is substantially the same as a comparable provision in the Global Settlement, seeks to address potential conflicts of interest during the period that firms market securities offerings for issuers. While the SRO staffs believe this provision is operating effectively, some members have asked for additional guidance on whether research analysts can listen to or view an investment banking or company-sponsored road show or other presentation to investors or the analysts' sales force.

The SRO staffs note that the SEC has provided interpretive guidance on the parallel provision of the Global Settlement and concluded that it would not be inconsistent with this provision to permit research analysts to listen to ("listen-only" mode, not identified as being present), or view a live Webcast of a road show or other widely attended presentation to investors or the sales force, so long as access is from a remote location (*i.e.*, not at the same address as investment banking, investors or the sales force). The SEC has further stated that if the road show or other widely attended presentation to investors or the sales force is conducted at the firm's offices, research personnel may listen-in from the same address as investment banking, investors or the sales force, but may not be in the same room as investment banking, investors or the sales force. The SRO staffs generally agree with that guidance and intend to address this area in more detail in a future interpretive memorandum.

5. Restrictions on Publishing Research Reports and Public Appearances

Current Rules

The SRO Rules set forth, in accordance with the mandates of Sarbanes-Oxley, "quiet periods" during which a member is prohibited from publishing or otherwise distributing a research report and a research analyst is prohibited from making a public appearance. These quiet periods apply in two circumstances: (1) after a public offering of securities and (2) before and after the expiration, waiver or termination of a lock-up agreement entered into by a member with a subject company that restricts the sale of securities by that company or its shareholders.

With respect to the former, the SRO Rules establish different quiet periods depending on whether the offering is an IPO or secondary offering and whether the member acted as manager or co-manager. A member that acted as a manager or co-manager of an IPO may not publish or otherwise distribute research for 40 calendar days following the date of the offering; all other members that participated as an underwriter or dealer in the offering are subject to a 25-day quiet period. A ten-day quiet period applies only to the manager and co-manager of a secondary offering.

The rules contain an exception that permits publication and distribution of research or a public appearance concerning the effects of "significant news or a significant event on the subject company" during the quiet period. The SRO staffs have interpreted this exception to apply only to news or events that have a material impact on, or cause a material change to, a company's operation, earnings or financial condition. Another exception to the secondary offering quiet period permits publication or distribution of research pursuant to SEC Rule 139 regarding a subject company with "actively-traded securities" as defined in SEC Regulation M.

Recommended Changes

The SRO staffs recommend several changes to the quiet periods surrounding public offerings and lock-up expirations. In some cases, the SRO staffs offer alternative recommendations to address these issues.

(a) Quiet periods following public offerings of securities

The SRO staffs recommend unifying the IPO quiet periods for all underwriters and dealers participating in the offering and tying them to the SEC's rules regarding publication and distribution of research. As such, the SRO staffs recommend amending the rules to apply a 25-day quiet period to managers, co-managers, underwriters and dealers that participate in an IPO, unless publication or distribution of the report or the public appearance is permitted by SEC rule or interpretation.

The lengthier quiet period for managers and co-managers was intended to allow other voices to publicly analyze and value a subject company before managers and co-managers – those members vested with the greatest interest in seeing the stock price of the subject company go up – weighed in with their reports and public appearances. At the time this provision was enacted, it had been commonplace for managers and co-managers to initiate coverage with a positive rating on a company they just brought public, irrespective of whether the stock price had already risen well beyond the public offering price.

However, the SRO staffs recently have observed more circumstances where managers and co-managers have been neutral or even negative with their initial post-quiet period report based on price appreciation or other factors. Accordingly, the SRO staffs believe that the objectivity safeguards of the SRO Rules and the certification requirement of SEC Regulation AC have obviated the need for a longer quiet period for managers and co-managers than other underwriters and dealers participating in an IPO. The SRO staffs also believe the change would promote more information flow to investors and consistency with SEC regulations.

For some of the same reasons, the SRO staffs also recommend eliminating the quiet periods following a secondary offering. Coupled with the protections of SEC Regulation AC and other SRO Rule provisions, the SRO staffs believe that repeal of this provision would advance the SEC's purpose in its Securities Offering Reform rules to expand the ability of issuers to release more information regarding their prospects and financial condition, without sacrificing the reliability of the research. Along those lines, the existing SRO Rules already provide exceptions for research reports on issuers with "actively-traded securities" as defined in SEC Regulation M.

(b) Quiet periods around releases of lock-up agreements

The NASD staff recommends eliminating the quiet periods around the expiration, waiver or termination of a lock-up agreement, provided members include an additional statement as part of their SEC Regulation AC certification – or, alternatively, a separate certification – for research issued during such periods. The quiet periods surrounding lock-up releases are intended to prevent abusive "booster shot" reports by members to raise the stock price of a company just before previously locked-up shares become freely saleable into the market by a company or its major shareholders. While the SRO staffs continue to share the concern expressed by the former

Acting Chair of the SEC[137] that these periods pose heightened concerns about biased research, the changes to internal structure of investment banks and the other safeguards imposed by the rules appear to the NASD staff to have addressed these concerns, and have obviated the need for a quiet period that inhibits the flow of information to the marketplace. Moreover, the NASD staff believes that practical limitations inhibit effective administration of the provision. Most notably, the SRO Rules do not require lock-up agreements, and the SROs often have no jurisdiction over parties to them, including the subject company and its non-member shareholders. The SROs therefore cannot always be the arbiter of whether certain facts constitute, for example, a waiver or termination of a lock-up – a significant impediment to the SROs' ability to enforce this provision.

The NASD staff notes that under no circumstances are overly optimistic reports acceptable, whether or not they occur around the expiration of a lock-up. To that end, the SRO Rules require a reasonable basis for any recommendation or price target and the valuation method used to determine a price target, while SEC Regulation AC requires certification that any such recommendation or price target be genuinely held. Accordingly, the NASD staff believes an effective alternative to the quiet periods would be to require that members include under Regulation AC, or separately, an additional certification to having a bona fide reason for issuing research within 15 days before and after a lock-up expiration.

On the other hand, the NYSE staff believes that the quiet period surrounding the expiration, termination or waiver of a lock-up agreement should be maintained but perhaps reduced from the current 15-day period to a five-day period. The NYSE staff believes that the regulatory concerns that precipitated the promulgation of the prohibitions are still present. That is, the NYSE staff is concerned that, absent a quiet period around the release of lock-up agreements, member firms may issue "booster shot" reports that are intended to raise the stock price of a company just before locked-up shares become freely saleable into the market by a company or its major shareholders. The NYSE staff believes that, while the certification requirement of SEC Regulation AC may have obviated the need for a longer quiet period for managers and co-managers than other underwriters and dealers participating in an IPO, it does not support the elimination of quiet periods around the release of lock-up agreements.

With respect to operational issues, the NYSE staff observes that the comments and concerns initially made at the time of the rule proposal have not materialized. In this regard, there have not been instances when the NYSE staff has found co-managers to have inadvertently published research in violation of the quiet periods surrounding the waiver of lock-up agreements granted by lead managers.[138]

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[137] Unger Testimony, *supra* note 5, at 229, 235.

[138] The NYSE/NASD IPO Advisory Committee made the following recommendations: (1) require prospectuses to include a clear description of lock-up agreements and whether the underwriter expects to grant exceptions relating to hedging or other transactions; and (2) require improved disclosure regarding exemptions by an underwriter to an IPO lock-up agreement, by mandating that underwriters notify issuers prior to granting any exemption to a lock-up, and require issuers to file a current report on Form 8-K at least one business day prior to the time the insider commences the transaction, and also that prior to the transaction, the lead underwriter announces the exemption by broad communications to the investment community through a major news service. *See also* Securities Exchange Act Release No. 50896 (Dec. 20,

Moreover, the NYSE staff notes that while the NYSE may not have jurisdiction over some of the participants to such agreements (*e.g.*, the company and its shareholders), it does retain jurisdiction over its member organizations that can issue research and as such can limit the potential for any untoward conduct by maintaining this prohibition.

Lastly, the NYSE staff notes the recent strength of the IPO market[139] and that such offerings generally contain lock-up agreements. Accordingly, it believes that at this juncture it is appropriate to maintain a form of prohibition absent some compelling empirical data/evidence to the contrary.

(c) Exceptions to quiet periods

As noted above, the rules contain an exception that permits publication and distribution of research or a public appearance concerning the effects of "significant news or a significant event on the subject company" during the quiet period. The SRO staffs have interpreted this exception to apply only to news or events that have a material impact on, or cause a material change to, a company's operations, earnings or financial condition and that generally would trigger the filing requirements of SEC Form 8-K. The SROs have not interpreted the exception to include earnings announcements absent some other significant news or significant event because it was felt that they generally are not a causal event or news items that materially affects a company's operations, earnings or financial condition.

The NYSE staff believes that exceptions to quiet periods should be consistent with SEC requirements for the filing of Forms 8-K. In this regard, Item 2.02 (Results of Operations and Financial Conditions) of Form 8-K requires, in part, a filing of such form if a registrant makes any public announcement or release (including any update of an earlier announcement or release) disclosing material non-public information regarding its results of operations or financial condition. Accordingly, the NYSE staff recommends including an announcement of earnings as an exception to the quiet periods as it will be consistent with SEC requirements and maintain a flow of potentially sensitive information to the market and investors in a timely manner.[140] The NYSE staff also believes that an announcement of a change to earnings will, in all likelihood, be accompanied by an announcement of some type of causal events. Further, earnings announcements and guidance are necessary pipelines of information for research analysts to support the basis of their investment recommendations.

2004), 69 FR 77804 (Dec. 28, 2004) (notice of filing of proposed NYSE Rule 470 and NASD Rule 2712 which would codify, in part, the above recommendations) (SR-NYSE-2004-12 and SR-NASD-2003-140).

139 In 2005, there have been 61 IPOs so far that have listed on the NYSE. In 2004, there were 69 NYSE-listed IPOs. Further, in a recent *Wall Street Journal* article, it was noted that "there are 115 initial public offerings of stock valued at $20.9 billion waiting to price in the U.S. in 2006, according to data from deal tracker Dealogic LLC." Lynn Cowan, *IPO Market Looks Strong in 2006*, Wall St. J., Dec. 19, 2005, at C4.

140 The SEC recognized the importance of timely dissemination of information to the marketplace in its recent amendments to Form 8-K in which it shortened the filing deadline to four business days after the occurrence of an event triggering the disclosure requirements of the form. *See* Securities Act Release No. 8400 and Securities Exchange Act Release No. 49424 (Mar. 16, 2004), 69 FR 15594 (Mar. 25, 2004).

The NASD staff does not believe it is necessary to revise the quiet period exceptions to include any event that triggers the filing of a Form 8-K. The NASD staff continues to believe that earnings announcements are not causal occurrences that, in and of themselves, connote significant news or significant events that materially impact a subject company's financial condition or operations. Moreover, in the NASD staff's experience, abolition of the quiet periods around releases of lock-up agreements would largely obviate the need to expand the "significant news" exception. These issues have arisen mainly because an earnings announcement has occurred or will occur within 15 days of the expiration, waiver or termination of a lock-up agreement. As noted above, the NASD staff further believes that abolition of the quiet periods around releases of lock-up agreements would increase information flow to the marketplace.

6. Restrictions on Personal Trading by Research Analysts

Current Rules

NASD Rule 2711(g) and NYSE Rule 472(e) generally restrict the trading of securities by "research analyst accounts."[141] Specifically, NASD Rule 2711(g) and NYSE Rule 472(e) prohibit any research analyst account from:

- purchasing or receiving any securities before the issuer's initial public offering if the issuer is principally engaged in the same types of business as companies that the research analyst follows;
- purchasing or selling any security issued by a company that the research analyst follows, or any option or derivative of such a security, for a period beginning 30 days before and ending five days after the publication of a research report concerning the company or a change in a rating or price target of the company's securities; and
- purchasing or selling any security or option or derivative of such a security in a manner inconsistent with the analyst's most recent recommendation.

The rules include exceptions to these trading restrictions for certain trades that:

- are due to unanticipated significant changes in an analyst's personal financial circumstances;
- occur within the 30-day/five-day trading blackout around the publication of a report if the report is issued due to a significant news event;

141 NASD Rule 2711(a)(6) defines the term "research analyst account" to include any account in which a research analyst or member of the analyst's household has a financial interest, or over which the analyst has discretion or control, other than an investment company registered under the Investment Company Act of 1940. The term does not include a "blind trust" account that is controlled by a person other than the research analyst or household member and neither the analyst nor any household member knows of the account's investments or investment transactions. Although NYSE Rule 472 does not employ the term "research analyst account," the trading restrictions of NYSE Rule 472(e) and NASD Rule 2711(g) are coterminous. *See* NYSE Rule 472.40.

- occur within 30 days after an analyst initiates coverage of a company;
- involve shares of diversified registered investment companies; and
- involve interests in an investment fund over which neither the analyst nor a household member has any investment discretion or control, the research analyst accounts collectively own no more than 1% of the fund's assets, and the fund invests no more than 20% of its assets in securities of issuers principally engaged in the same types of business as companies that the analyst follows.

NASD Rule 2711(g) and NYSE Rule 472(e) also require legal or compliance personnel to pre-approve all trades of persons who oversee research analysts to the extent such trades involve equity securities of subject companies covered by the analysts they oversee.

Recommended Changes

Members have suggested the SROs make two principal changes to the personal trading restrictions. First, members have urged the SROs to expand the exceptions to the personal trading restrictions to include any investments in funds not controlled by the research analyst or member of his or her household, regardless of whether the fund is registered as an investment company and regardless of its holdings. Second, some members that wish to go beyond the SRO Rules and ban ownership of securities covered by their analysts have asked the SROs to provide a means for those analysts to divest their holdings without violating the blackout period and trading against recommendation prohibitions.

The SRO staffs generally agree with these comments and therefore recommend the following changes to the exceptions to the SRO Rules' personal trading restrictions.

First, the SRO staffs recommend revising the exceptions to the personal trading restrictions for investment funds. The current rules do not apply the personal trading restrictions to investments in diversified registered investment companies and funds that meet certain percentage-of-assets tests. The SRO staffs recommend that the personal trading restrictions instead not apply to investments in any fund so long as neither the analyst nor a member of his or her household is aware of the fund's holdings or transactions other than through periodic shareholder reports and sales material based on such reports, and provided that the research analyst account owns no more than 1% of the assets of the fund.

This would simplify the ability of analysts to invest in mutual funds, variable insurance products and hedge funds that do not disclose their holdings other than through periodic reports or sales material based on such reports. The SRO staffs believe that absent discretion or control of an account or the contemporaneous knowledge of the account's transactions, a minimal investment by a research analyst will not tempt the analyst to compromise research objectivity to benefit the account.

Second, the SRO staffs recommend creating an exemption for firms that voluntarily choose to prohibit their analysts from owning shares of the companies they cover. The exemption would allow such a firm to adopt policies that permit research analysts to divest their holdings in an orderly and controlled way with the oversight of the firm's legal and compliance personnel. The SRO staffs permitted firms to allow their analysts to divest their holdings in the same manner when the rule first became effective by delaying for a certain time period implementation of the personal trading restrictions for firms that wished to ban ownership. With the recommended change, the rule would allow firms that adopt ownership bans to implement the same divestiture procedures regardless of when they adopted such a policy.

7. Disclosure Requirements

Current Rules

NASD Rule 2711(h) and NYSE Rule 472(k) impose a number of disclosure requirements on member research reports and research analyst public appearances in which the analyst makes a recommendation or offers an opinion concerning an equity security. The rules require specific disclosures of conflicts of interest, including where the member firm, the research analyst or a member of the analyst's household has a financial interest in the subject company's securities or the member or its affiliates have received compensation from the subject company. The rules also require a number of non-conflicts related disclosures in research reports, including the meanings of ratings used in the member's rating system, the distribution of buy, hold, and sell ratings assigned by the member, and a price chart that plots the assignment or changes of the analyst's ratings and price targets for the subject company against the movement of the subject company's stock price over time.

Recommended Changes

The SRO staffs have found that these required disclosures promote transparency and provide important information to enable investors to assess the value of the research in making their investment decision. However, the SRO staffs are concerned that the sheer volume of the disclosures may obscure the overall message that the disclosures are attempting to convey: that the member or research analyst faces conflicts of interest with respect to the subject company. This problem is compounded by the fact that many members include additional disclosures required by other jurisdictions, as well as sometimes lengthy disclaimers for their own purposes. The SRO staffs believe that it would be more effective and useful to investors to know immediately whether the member firm or research analyst producing the research report is conflicted, while providing the reader the means to learn more about these conflicts if he or she chooses to do so.

To accomplish this result, the SRO staffs recommend amending the rules to require that, in lieu of publication in the research report itself, member firms disclose their conflicts of interest related to research reports by including a prominent warning on the cover of a research report that such conflicts of interest exist, together with information on how the reader may obtain more detail about these conflicts on the member's Web site. A member would then be required to include detailed conflicts information on its Web site. The SRO staffs believe that this disclosure system would be more effective to warn the reader of such conflicts than the current system of disclosing all conflicts in the back of the report.

The SEC has considered using this approach elsewhere to disclose the existence of conflicts of interest to investors. For example, the SRO staffs understand that in its mutual fund point-of-sale disclosure proposal,[142] the SEC staff found that most investors only want to know about whether a conflict exists, rather than receiving quantitative or lengthy disclosure about the precise nature of those conflicts. For that reason, the SEC has proposed requiring a "Yes/No" disclosure of whether a dealer receives revenue sharing or pays differential compensation with respect to the sale of mutual funds. The SEC would require that more detailed disclosure about the nature of any conflicts be provided separately on a mutual fund's Web site.

Similarly, in commenting on the SEC point-of-sale disclosure proposal, the NASD Mutual Fund Task Force recommended Internet delivery of point-of-sale documents and prospectuses, a recommendation that NASD supports.[143] The Task Force argued that Internet delivery would enable investors to obtain the level of disclosure that they wanted in electronic form.

The SRO staffs believe that the research analyst conflict of interest rules similarly lend themselves to a more targeted means of disclosure. The SRO staffs therefore suggest amending the SRO Rules to require conflicts of interest disclosure along the lines of the SEC's point-of-sale proposal and NASD's Internet delivery recommendations for mutual fund related disclosures. This disclosure requirement would ensure that investors obtain prominent disclosure that a research-related conflict exists, and would permit investors to find additional information about the conflict on the member's Web site. It is possible that a similar approach could be used for disclosure of conflicts in public appearances, as long as the existence of such conflicts is clearly communicated.

The SRO staffs generally do not believe that vague, so-called "health warnings" that conflicts of interest "may or may not" exist are useful or effective. In this regard, the SRO Rules would still require disclosure based on actual conflicts of interest, rather than the possibility of such conflicts.

The SRO staffs do not recommend Web site disclosure for the non-conflicts related disclosures, such as the meanings of the member's ratings and the price chart showing the subject company's price movements against the analyst's assignments of ratings and price targets. The SRO staffs believe that these disclosures provide useful information that should be readily available to investors, particularly since they would not be encompassed by the recommended conflict warning on the cover of the report.

Finally, the SRO staffs recommend the inclusion of non-substantive, technical changes to certain disclosure requirements in order either to codify past SRO interpretations of the rules or to clarify the rules' intent. For example, a research report is required to disclose the meanings of ratings used in the member's ratings system only if the report actually includes a rating of the subject company. Similarly, a price chart is not required for reports that do not include a rating or price target. In addition, the SRO staffs recommend including the disclosure requirements for third-party research reports, which are discussed in NASD *Notices to Members* 02-39 (July

142 Securites Act Release No. 8544 (Feb. 28, 2005), 70 FR 10521 (Mar. 4, 2005).

143 Report of the Mutual Fund Task Force: Mutual Fund Distribution (Mar. 2005), http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_013690.pdf.

2002) and 04-18 (Mar. 2004) and NYSE Information Memos 02-26 (June 26, 2002) and 04-10 (Mar. 9, 2004), in the SRO Rules' text.

8. Prohibition on Retaliation Against Research Analysts

Current Rules

The SRO Rules currently prohibit any member and any employee of a member who is involved with the member's investment banking activities from directly or indirectly retaliating against a research analyst as a result of an unfavorable research report or public appearance that may adversely affect the member's current or prospective investment banking relationship with a subject company.

Recommended Changes

The SRO staffs believe that under no circumstances is retaliation appropriate against a research analyst who expresses his or her truly held beliefs about a subject company. As such, the SRO staffs recommend amending this provision to extend the retaliation prohibition to all employees, not just those involved in investment banking activities.

9. Prerequisites for the Research Analyst Qualification Examination

Current Rules

As detailed in Section II, the SRO Rules require an associated person who functions as a research analyst on behalf of a member to register as such and pass the Research Analyst Qualification Examination (Series 86/87) or qualify for an exemption. Prior to taking either the Series 86 or 87, a candidate also must have passed the General Securities Registered Representative Examination (Series 7), the Limited Registered Representative Examination (Series 17), or the Canada Module of Series 7 (Series 37 or 38).

The SRO staffs believe it is important for those functioning as research analysts to be familiar with general industry rules and practices, particularly those of registered representatives, who are a primary source for distributing research. The SRO staffs believe that the topics on the Series 7 and other eligible prerequisite examinations further develop a sensitivity in research analysts to the interests of public customers who are the end users of their work product. The SRO staffs note that a committee of research analysts who were consulted in the development of the Series 86/87 examination program unanimously recommended that research analysts be required to pass the Series 7 in addition to a more job-specific research analyst qualification examination.

Recommended Changes

Several industry members have asked the SROs to consider eliminating the Series 7 or alternative prerequisite exam. These firms argue that research analysts should only be tested on job-specific requirements, and that relevant topics on the Series 7 examination should instead be imported to the Series 86/87 examinations. The SRO staffs recommend considering this suggestion, as well as the possibility of substituting for the Series 7 prerequisite a new Capital Market Professional Examination that is being developed jointly by NASD, the NYSE and regulators in the United Kingdom. While the content of the latter examination has not yet been precisely determined, it is anticipated that the concepts tested may provide an adequate foundation of general industry rules and practices for research analysts. The SRO staffs will be better situated to evaluate this alternative once the new examination has been fully developed and approved by the SEC.

C. Other Issues

1. Fixed-Income Research

On May 19, 2004, The Bond Market Association ("BMA") issued its "Guiding Principles to Promote the Integrity of Fixed Income Research," which are voluntary principles designed to help firms manage potential conflicts of interest that may arise in their fixed-income research activities.[144] According to the BMA, its Guiding Principles were designed to recognize the significant differences between fixed-income research and equity research, as well as the important differences in research regarding individual fixed-income asset classes.

The SRO staffs do not believe it is appropriate at this time to codify any of these principles or amend the SRO Rules to extend their provisions to fixed-income research. Instead, the SROs are monitoring the extent to which firms have adopted the BMA Guiding Principles and will consider further rulemaking after assessing the effectiveness of voluntary compliance. Meanwhile, the SRO staffs believe that the anti-fraud statutes, as well as existing SRO rules, such as NASD Rule 2110's requirement that members "observe high standards of commercial honor and just and equitable principles of trade" and similar obligations under NYSE Rules 401 and 476(a)(6), can reach any egregious conduct involving fixed-income research.

2. Issuer Retaliation

As noted above, the source of analysts' conflicts was not limited solely to their investment banking relationships, but also included pressure stemming from issuer retaliation. Issuer retaliation can consist of limiting an analyst's access to company management or participation in conference calls, and interfering with other company relationships (such as by prohibiting the analyst's firm from managing an issuer's pension plan). The SRO Rules have insulated analysts from internal pressures from investment banking personnel by prohibiting retaliation by a member against a research analyst for issuing an unfavorable research report that adversely affects a firm's investment banking relationship with an issuer. The prohibition against investment banking personnel's supervising or controlling analysts or participating in the determination of analyst compensation also protects the analyst from retaliation by the investment banking department.

Protection from retaliation by an issuer rather than the investment bank is a more difficult problem to solve. The issue could be addressed through listing standards. However, the NYSE does not believe amendments to its listing standards and its limited ability to enforce such standards by delisting is practicable. In this regard, issuer retaliation, unlike other prohibited

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144 *See* Guiding Principles To Promote Integrity of Fixed Income Research, May 2004, http://www.bondmarkets.com/assets/files/Guiding_Principles_for_Research.pdf.

firm conduct, is very fact specific, qualitative rather than quantitative in nature and difficult to evaluate and discern with absolute certainty.

Accordingly, the NYSE would like to see the practical impact of the CFA/NIRI "Best Practice Guidelines Governing Analyst/Corporate Issuer Relations" which it has endorsed and communicated to its listed companies.[145] It will continue to monitor the impact of such Best Practices and will continue to engage the SEC in dialogue to explore other practical ways to address this issue.

3. Foreign Regulatory Initiatives

In addition to the SROs, regulators in such jurisdictions as the United Kingdom,[146] Canada,[147] Japan,[148] and Australia[149] have implemented or proposed research analyst conflict of interest rules in some form. Organizations such as the International Organization of Securities Commissions ("IOSCO") also have issued guidelines and best practices for their members.[150] And the European Union Forum Group ("EU") released a set of recommendations involving research analyst conflicts to be included in a directive targeting market abuse and promoting uniform regulations among the different European Union securities markets.[151]

These regulatory models share a common goal of reducing bias in the production and dissemination of research. At the same time, the various initiatives by these regulatory groups demonstrate that there are a number of approaches to eliminating research analyst conflicts: some organizations, like IOSCO and the EU, recommend best practices but do not impose

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145 The NYSE recently issued a letter to its listed companies encouraging them to consider implementing CFA/NIRI Best Practice Guidelines Governing the Relationship between Analysts and Corporate Issuers. *See* letter dated October 11, 2005 from Richard G. Ketchum, Chief Regulatory Officer, NYSE, to Exchange Listed Companies.

146 Regulations by the Financial Services Authority, "Discussion Paper No. 15" and "Consultation Paper 171," July 2002 and December 2003, respectively.

147 Report issued by Securities Industry Committee on Analyst Standards, which was established by the Toronto Stock Exchange, the Investment Dealers Association ("IDA") and the Canadian Venture Exchange. The report, entitled "Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts" was released in November 2001. IDA "Policy 11, Analyst Standards," was issued in June and December 2002.

148 Japanese Securities Dealers Association, "Rules for Handling Analysts' Reports," January 2002, revised January 2003.

149 Securities Institute of Australia and the Securities and Derivatives Industry Association, "Best Practices Guidelines for Research Integrity," November 2001.

150 IOSCO is an international organization whose members cooperate to promote high standards of regulation to protect investors and ensure that markets are fair, efficient and transparent. In September 2003, the Technical Committee of IOSCO issued a Statement of Principles to guide securities regulators and others in addressing the conflicts of interest securities analysts may face. These principles are combined with certain more specific measures designed to eliminate or manage analysts' conflicts of interest. The Statement of Principles can be found at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD150.pdf.

151 This group issued a Report and the "Market Abuse Directive" to implement a uniform system of regulation to handle market abuses in the European Union. The Market Abuse Directive was first issued in December 2002.

regulations, while the SRO Rules and rules promulgated by the other regulators take a more prescriptive approach. These diverse regulatory models sometimes result in differing requirements that can pose challenges for firms with global research operations.

The SRO staffs support ongoing discussions with their members and international regulatory groups to promote the most effective and efficient means to manage research analyst conflicts of interest and to ensure reliable and objective research throughout the world.

VI. CONCLUSION

The SRO staffs believe that the SRO Rules have been effective in helping to restore integrity to research by minimizing the influences of investment banking and promoting transparency of other potential conflicts of interest. Evidence also suggests that investors are benefiting from more balanced and accurate research to aid their investment decisions. The SRO staffs believe that certain changes to the SRO Rules would further improve their effectiveness by striking an even better balance between ensuring objective and reliable research on the one hand and permitting the flow of information to investors and minimizing costs and burdens to members on the other.

Rule 472. Communications With The Public

Approval of Communications and Research Reports

(a)(1) Each advertisement, market letter, sales literature or other similar type of communication which is generally distributed or made available by a member or member organization to customers or the public must be approved in advance by a member, allied member, supervisory analyst, or qualified person designated under the provisions of Rule 342(b)(1).

(2) Research reports must be prepared or approved, in advance, by a supervisory analyst acceptable to the Exchange under the provisions of Rule 344. Where a supervisory analyst does not have technical expertise in a particular product area, the basic analysis contained in such report may be co-approved by a product specialist designated by the organization. In the event that the member organization has no principal or employee qualified with the Exchange to approve such material, it must be approved by a qualified supervisory analyst in another member organization by arrangement between the two member organizations.

Investment Banking, Research Department and Subject Company Relationships and Communications

(b)(1) Research analysts may not be subject to the supervision, or control, of any employee of the member's or member organization's investment banking department and personnel engaged in investment banking activities may not have any influence or control over the compensatory evaluation of a research analyst.

(2) Research reports may not be subject to review or approval prior to publication by Investment Banking personnel or any other employee of the member or member organization who is not directly responsible for investment research ("non-research personnel") other than Legal or Compliance personnel.

(3) Non-research personnel may review research reports prior to publication only to verify the factual accuracy of information in the research report or to identify any potential conflicts of interest that may exist, provided that:

(i) any written communication concerning the content of research reports between non-research personnel and Research personnel must be made either through Legal or Compliance personnel or in a transmission copied to Legal or Compliance personnel; and

(ii) any oral communication concerning the content of research reports between non-research personnel and Research personnel must be documented and made either with Legal or Compliance personnel acting as intermediary or in a conversation conducted in the presence of Legal or Compliance personnel.

(4) A member or member organization may not submit a research report to the subject company prior to publication, except for the review of sections of a draft of the research report solely to verify facts. Members and member organizations may not, under any circumstances, provide the subject

company sections of research reports that include the research summary, the research rating or the price target.

(i) Prior to submitting any sections of the research report to the subject company, the Research Department must provide a complete draft of the research report to the Legal or Compliance Department.

(ii) If after submission to the subject company, the Research Department intends to change the proposed rating or price target, the Research Department must provide written justification to, and receive prior written authorization from, the Legal or Compliance Department for any change. The Legal or Compliance Department must retain copies of any drafts and changes thereto of the research reports provided to the subject company.

(iii) The member or member organization may not notify a subject company that a rating will be changed until after the close of trading in the principal market of the subject company one business day prior to the announcement of the change.

(5) A research analyst is prohibited from participating in efforts to solicit investment banking business. This prohibition includes, but is not limited to, participating in meetings to solicit investment banking business (e.g., " pitch" meetings) of prospective investment banking clients, or having other communications with companies for the purpose of soliciting investment banking business. This prohibition shall not apply to any communication between the research analyst, company, and/or non-research personnel, the sole purpose of which is due diligence.

(6)(i) A research analyst is prohibited from directly or indirectly:

(a) participating in a road show related to an investment banking services transaction; and

(b) engaging in any communication with a current or prospective customer (s) in the presence of investment banking department personnel or company management about an investment banking services transaction.

(ii) Investment banking department personnel are prohibited from directly or indirectly:

(a) directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction; and

(b) directing a research analyst to engage in any communication with a current or prospective customer(s) about an investment banking services transaction.

(iii) Research analyst written and oral communications relating to an investment banking services transaction, with a current or prospective customer(s), or with internal personnel, must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

Written Procedures

(c) Each member and member organization must establish written procedures reasonably designed to ensure that members, allied members, member organizations and their employees are in compliance with this Rule (see Rule 351(f) and Rule 472(h)(2) for attestations to the Exchange regarding compliance).

Retention of Communications

(d) Communications with the public prepared or issued by a member or member organization must be retained in accordance with Rule 440 ("Books and Records"). The names of the persons who prepared and who reviewed and approved the material must be ascertainable from the retained records and the records retained must be readily available to the Exchange, upon request.

Restrictions on Trading Securities by Associated Persons

(e)(1) No research analyst or household member may purchase or receive an issuer's securities prior to its initial public offering (e.g., so-called pre-IPO shares), if the issuer is principally engaged in the same types of business as companies (or in the same industry classification) which the research analyst usually covers in research reports.

(2) No research analyst or household member may trade in any subject company's securities or derivatives of such securities that the research analyst follows for a period of thirty (30) calendar days prior to and five (5) calendar days after the member's or member organization's publication of research reports concerning such security or a change in rating or price target of a subject company's securities.

(3) No research analyst or household member may effect trades in a manner inconsistent with the research analyst's most current recommendations (i.e., sell securities while maintaining a "buy" or "hold" recommendation, buy securities while maintaining a "sell" recommendation, or effecting a "short sale" in a security while maintaining a "buy" or "hold" recommendation on such security).

(4) Listed below are exceptions to the prohibitions contained in paragraphs (1), (2), and (3) (Each exception granted must be in compliance with policies and procedures adopted by the member or member organization that are reasonably designed to ensure that transactions effected pursuant to these exceptions do not create a conflict of interest between the professional responsibilities and the personal trading activities of the research analyst and/or his or her household member.):

(i) transactions by research analysts and/or household members that have been pre-approved in writing by the Legal or Compliance Department that are made due to an unanticipated significant change in their personal financial circumstances;

(ii) a member or member organization may permit the publication of research reports or permit a change to the rating or price target on a subject company, regardless of whether a research analyst and/or household members traded the subject company's securities or derivatives of such securities, within the thirty (30) calendar day period described in paragraph (e)(2), when the publication of such research reports, or change in such rating or price target is attributable to some significant news or events regarding the subject company, provided that the publication of such research reports, or change in rating or price target on such subject company has been pre-approved in writing by the Legal or Compliance Department;

(iii) sale transactions by a research analyst, who is new to the member or member organization, and/or his or her household members within thirty (30) calendar days of such research analyst's employment with the member or member organization when such research analyst and/or household members had previously purchased such security or derivatives of such security prior to the research analyst's employment with the member or member organization;

(iv) sale transactions by a research analyst and/or household member within thirty (30) calendar days from the date of the member's or member organization's publication of research reports or changes to the rating or price target on a subject company when such research analyst and/or household members had previously purchased the subject company's securities or derivatives of such securities prior to initiation of coverage of the subject company by the research analyst;

(v) transactions in accounts not controlled by the research analyst and for investment funds in which a research analyst or household member has no investment discretion or control, provided the interest of the research analyst or household member in the assets of the fund does not exceed 1% of the fund's assets, and the fund does not invest more than 20% of its assets in securities of issuers principally engaged in the same types of business as companies (or in the same industry classification) which the research analyst usually covers in research reports. If an investment fund distributes securities in kind to a research analyst before the issuer's initial public offering, the research analyst must either divest those securities immediately or refrain from participating in the preparation of research reports concerning that issuer;

(vi) transactions in a registered diversified investment company as defined under Section 5(b)(1) of the Investment Company Act of 1940.

(5) No person who supervises research analysts (e.g., Director of Research), a Supervisory Analyst, or a member of a committee, who has direct influence and/or control with respect to (1) preparing the substance of research reports, or (2) establishing or changing a rating or price target of a subject company's equity securities, may effect trades in securities of companies that are the subject of such research reports, or ratings or price target changes, without the prior approval of the Legal or Compliance personnel of the member or member organization.

(6) Members and member organizations must maintain written records for each transaction and the justification for permitting such transactions for three years following the date the transactions were made pursuant to the exceptions provided for in Rule 472(e)(4)(i)-(iv), and (5).

Restrictions on Member's or Member Organization's Issuance of Research Reports and Participation in Public Appearances

(f)(1) A member or member organization may not publish or otherwise distribute research reports regarding an issuer and a research analyst may not recommend or offer an opinion on an issuer's securities in a public appearance, for which the member or member organization acted as manager or co-manager of an initial public offering within forty (40) calendar days following the offering date.

(2) A member or member organization may not publish or otherwise distribute research reports regarding an issuer and a research analyst may not recommend or offer an opinion on an issuer's securities in a public appearance, for which the member or member organization acted as manager or co-manager of a secondary offering within ten (10) calendar days following the offering date. This prohibition shall not apply to public appearances or research reports published or otherwise distributed under Securities Act Rule 139 regarding issuers whose securities are actively traded, as defined in Securities Exchange Act Rule 101(c)(1) of Regulation M.

(3) No member or member organization that has agreed to participate or is participating as an underwriter or dealer (other than as manager or co-manager) of an issuer's initial public offering may publish or otherwise distribute a research report regarding that issuer and a research analyst may not recommend or offer an opinion on that issuer's securities in a public appearance for twenty-five (25) calendar days following the offering date.

(4) No member or member organization which has acted as a manager or co-manager of a securities offering may publish or otherwise distribute a research report and a research analyst may not recommend or offer an opinion on an issuer's securities in a public appearance within fifteen (15) days prior to or after the expiration, waiver or termination of a lock-up agreement or any other agreement that the member or member organization has entered into with a subject company and its shareholders that restricts or prohibits the sale of the subject company's or its shareholders' securities after the completion of a securities offering. This prohibition shall not apply to public appearances or research reports published or otherwise distributed under Securities Act Rule 139 regarding issuers whose securities are actively traded, as defined in Securities Exchange Act Rule 101(c)(1) of Regulation M.

(5) A member or member organization may permit exceptions to the prohibitions in paragraphs (f)(1), (2), and (4) (consistent with other securities laws and rules) for research reports that are published or otherwise distributed or recommendations or opinions on an issuer's securities made in a public appearance due to significant news or events, provided that such research reports are pre-approved in writing by the

member's or member organization's Legal or Compliance personnel.

(6) If a member or member organization intends to terminate its research coverage of a subject company, notice of this termination must be made. The member or member organization must make available a final research report on the subject company using the means of dissemination equivalent to those it ordinarily uses to provide the customer with its research reports on the subject company. The report must be comparable in scope and detail to prior research reports and must include a final recommendation or rating, unless it is impracticable for the member or member organization to produce a comparable report (e.g., if the research analyst covering the subject company or sector has the left the employ of the member or member organization, or where the member or member organization terminates coverage on the industry or sector). In instances where it is impracticable for the member or member organization to provide a final recommendation or rating, the member or member organization must provide the rationale for the decision to terminate coverage.

Prohibition of Offering Favorable Research for Business

(g)(1) No member or member organization may directly or indirectly offer a favorable research rating or specific price target, or offer to change a rating or price target, to a subject company as consideration or inducement for the receipt of business or for compensation.

(2) No member or member organization and no employee of a member or member organization who is involved with the member's or member organization's investment banking activities may, directly or indirectly, retaliate against or threaten to retaliate against any research analyst employed by the member or member organization or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report written or public appearance made by the research analyst that may adversely affect the member's or member organization's present or prospective investment banking relationship with the subject company of a research report. This prohibition shall not limit a member's or member organization's authority to discipline or terminate a research analyst, in accordance with the member's or member organization's policies and procedures, for any cause other than the writing of such an unfavorable research report or the making of such unfavorable public appearance.

Restrictions on Compensation to Research Analysts

(h)(1) No member or member organization may compensate a research analyst for specific investment banking services transactions. A research analyst may not receive an incentive or bonus that is based on a specific investment banking services transaction. However, a member or member organization is not prohibited from compensating a research analyst based upon such member's or member organization's overall performance (see Rule 472(k)(1)(ii)a.2. for disclosure of such compensation).

(2) The compensation of a research analyst primarily responsible for the preparation of the substance of a research report must be reviewed and approved at least annually by a committee which reports to the Board of Directors or, where the member or member organization has no Board of

Directors, to a senior executive officer of the member or member organization. Such committee may not include representatives from the member's or member organization's Investment Banking Department. The committee must, among other things, consider the following factors, if applicable, when reviewing such research analyst's compensation:

i. The research analyst's individual performance, (e.g., productivity, and quality of research product);

ii. The correlation between the research analyst's recommendations and stock price performance;

iii. The overall ratings received from clients, sales force, and peers independent of the Investment Banking Department, and other independent rating services.

The committee may not consider as a factor in reviewing and approving such research analyst's compensation, his or her contributions to the member's or member organization's investment banking business.

The committee must document the basis upon which such research analyst's compensation was established. The annual attestation required by Rule 351(f) must certify that the committee reviewed and approved the compensation for each research analyst primarily responsible for the preparation of the substance of a research report and has documented the basis upon which such compensation was established.

General Standards for All Communications

(i) No member or member organization shall utilize any communication which contains (i) any untrue statement or omission of a material fact or is otherwise false or misleading; or (ii) promises of specific results, exaggerated or unwarranted claims; or (iii) opinions for which there is no reasonable basis; or (iv) projections or forecasts of future events which are not clearly labeled as forecasts.

Specific Standards for Communications

(j)(1) **Recommendations**

A recommendation (even though not labeled as a recommendation) must have a basis which can be substantiated as reasonable.

When recommending the purchase, sale or switch of specific securities, supporting information must be provided or offered.

The market price at the time the recommendation is made must be indicated.

(2) **Records of Past Performance**

Communications may feature record or statistics which portray the performance of past recommendations or of actual transactions of the member organization provided that the following conditions are met:

(i) The portrayal is balanced and consists of records or statistics that are confined to a specific "universe" that can be fully isolated and circumscribed and that covers at least the most recent 12-month period.

(ii) The communications include the date and price of each initial recommendation or transaction and the date and price of the recommendation or transaction at the end of the period or when liquidation was suggested or effected, whichever was earlier. Communications may also present summarized or averaged records of statistics or otherwise offer the complete record rather than provide it. This material must include the total number of items recommended or transacted, the number that advanced and declined and an offer to provide the complete record upon request.

(iii) The communications disclose the existence of all relevant costs, including commissions and interest charges or other applicable expenses and, whenever annualized rates of return are used, all material assumptions used in the process of annualization.

(iv) An indication is provided of the general market conditions during the period covered, and any comparison made between such records and statistics and an overall market (e.g., comparison to an index) is valid.

(v) The communications state that the results presented should not and cannot be viewed as an indicator of future performance.

(vi) All the original recommendations or evidence of actual transactions on which the record is based are retained for three years by the organization and made available to the Exchange on request.

(3) **Projections and Predictions**

Any projection or prediction must contain the bases or assumptions upon which they are made and must indicate that the bases or assumptions of the materials upon which such projections and predictions are made are available upon request.

(4) **Comparisons**

Any comparison of one member organization's service, personnel, facilities or charges with those of other firms must be factually supportable.

(5) **Dating Reports**

All communications must be appropriately dated. Any significant information that is not reasonably current (usually more than 6 months old—depending upon the industry and circumstances) must be noted.

(6) **Identification of Sources**

Communications not prepared under the direct supervision of the member organization or its correspondent member organization should show the person (by name and appropriate title) or outside organization which prepared the material.

In distributing communications prepared under the direct supervision of a correspondent member organization, the distributing firm should mention this fact, although it may not be necessary to identify the correspondent by name.

Communications about a corporate issuer which are distributed by a member organization but have been prepared and published by the issuer or for the issuer by a party other than the member organization should clearly identify the preparer and publisher.

(7) Testimonials

In testimonials concerning the quality of a firm's investment advice, the following points must be clearly stated in the communication:

(i) The testimonial may not be representative of the experience of other clients.

(ii) The testimonial is not indicative of future performance or success.

(iii) If more than a nominal sum is paid, the fact that it is a paid testimonial must be indicated.

(iv) If the testimonial concerns a technical aspect of investing, the person making the testimonial must have knowledge and experience to form a valid opinion.

Disclosure

(k)(1) Disclosures Required in Research Reports

Disclosure of Member's, Member Organization's, and Research Analyst's Ownership of Securities, Receipt of Compensation, and Subject Company Relationships

The front page of a research report either must include the disclosures required under this Rule or must refer the reader to the page(s) on which each such disclosure is found. Disclosures, and references to disclosures, must be clear, comprehensive, and prominent.

(i) A member or member organization must disclose in research reports:

a. if the member or member organization or its affiliates:

1. has managed or co-managed a public offering of securities for the subject company in the past twelve (12) months;

2. has received compensation for investment banking services from the subject company in the past twelve (12) months; or

3. expects to receive or intends to seek compensation for investment banking services from the subject company in the next three (3) months.

b. if the member or member organization is making a market in the subject company's securities at the time the research report is issued;

c. if, as of the last day of the month immediately preceding the date the publication (or the end of the second most recent month if the publication is less than ten (10) calendar days after the end of the most recent month), the member or member organization or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. The member or member organization must make the required beneficial ownership computation no later than ten (10) calendar days after the end of the prior month. Computation of beneficial ownership of securities must be based upon the same standards used to compute ownership for purposes of the reporting requirements under Section 13(d) of the Securities Exchange Act of 1934;

d. if, as of the last day of the month immediately preceding the date of publication of the research report (or the end of the second most recent month if the publication date is less than thirty (30) calendar days after the end of the most recent month):

1. the subject company currently is a client of the member or member organization or was a client of the member or member organization during the twelve (12)-month period preceding the date of distribution of the research report (In such instances, the member or member organization also must disclose the types of services provided to the subject company. For purposes of this paragraph, the types of services provided to the subject company may be described as investment banking services, non-investment banking-securities related services, and non-securities services.);

2. the member or member organization received any compensation for products or services other than for investment banking services from the subject company in the past twelve (12) months.

e. the valuation methods used, and any price objectives must have a reasonable basis and include a discussion of risks;

f. the meanings of all ratings used by the member or member organization in its ratings system (For example, a member or member organization might disclose that a "strong buy" rating means that the rated security's price is expected to appreciate at least 10% faster than other securities in its sector over the next twelve (12)-month period. Definitions of ratings terms also must be consistent with their plain meaning. Therefore, for example, a "hold" rating should not mean or imply that an investor should sell a security.);

g. the percentage of all securities that the member or member organization recommends an investor "buy," "hold," or "sell." Within each of the three (3) categories, a member or member organization must also disclose the percentage of subject companies that are investment banking services clients of the member or member organization within the previous twelve (12) months (see Rule 472.70 for further information);

h. a chart that depicts the price of the subject company's stock over time and indicates points at which a member or member organization assigned or changed a rating or price target. This provision would apply only to securities that have been assigned a rating for at least one (1) year, and need not extend more than three (3) years prior to the date of the research report. The information in the price chart must be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than fifteen (15) calendar days after the most recent calendar quarter).

(ii) A member or member organization must include the following disclosures in research reports:

a. if a research analyst received any compensation:

1. from the subject company in the past twelve (12) months;

2. that is based upon (among other factors) the member's or member organization's overall investment banking revenues.

b. if, to the extent the research analyst or an employee of the member or member organization with the ability to influence the substance of a research report, knows:

1. the subject company currently is a client of the member or member organization or was a client of the member or member organization during the twelve (12)-month period preceding the date of distribution of the research report. In such instances, such member or member organization also must disclose the types of services provided to the subject company (For purposes of paragraph (k)(1) of this Rule, the types of services provided to the subject company may be described as investment banking services, non-investment banking-securities related services, and non-securities services.). (For purpose of paragraph (k)(1) of this Rule, an employee of a member or member organization with the ability to influence the substance of the research report is an employee who, in the ordinary course of that person's duties, has the authority to review the particular research report and to change that research report prior to publication.);

2. that the member, member organization or any affiliate thereof, received any compensation for products or services other than investment banking services from the subject company in the past twelve (12) months.

(iii) A research analyst and a member or member organization must disclose in research reports:

a. if, to the extent the research analyst or member or member organization has reason to know, an affiliate of the member or member organization received any compensation for products or services other than investment banking services from the subject company in the past twelve (12) months;

1. This requirement will be deemed satisfied if such compensation is disclosed in research reports within thirty (30) days after completion of the most recent calendar quarter, provided that the member or member organization has taken steps reasonably designed to identify such compensation during that calendar quarter.

2. The member or member organization and the research analyst will be presumed not to have reason to know whether an affiliate received compensation for other than investment banking services from the subject company in the past twelve (12) months if the member or member organization maintains and enforces policies and procedures reasonably designed to prevent all research analysts and employees of the member or member organization with the ability to influence the substance of research reports from, directly or indirectly, receiving information from the affiliate concerning such compensation.

3. Paragraph 472(k)(1)(iii)a. shall not apply to any subject company as to which the member or member organization initiated coverage since the beginning of the current calendar quarter.

b. if the research analyst or a household member has a financial interest in the securities of the subject company, and the nature of the financial interest, including, without limitation, whether it consists of any option, right, warrant, futures contract, long or short position;

c. if the research analyst or a household member is an officer, director, or advisory board member of the subject company;

d. any other actual, material conflict of interest of the research analyst, or member or member organization, of which the research analyst knows, or has reason to know, at the time the research report is published or otherwise distributed.

When a member or member organization publishes or otherwise distributes a research report covering six (6) or more subject companies for purposes of the disclosures required in paragraph (k)(1) of this Rule, such research report may direct the reader in a clear and prominent manner as to where the reader may obtain applicable current disclosures in written or electronic format.

(k)(2) Disclosures Required in Public Appearances

Disclosure of Member's, Member Organization's, and Research Analyst's Ownership of Securities, Receipt of Compensation, and Subject Company Relationships

(i) A research analyst must disclose in public appearances:

a. if, as of the last day of the month before the appearance (or the end of the second most recent month if the appearance is less than ten (10) calendar days after the end of the most recent month), the member or member organization or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. The member or member organization must make the required beneficial ownership computation no later than ten (10) calendar days after the end of the prior month. Computation of beneficial ownership of securities must be based upon the same standards used to compute ownership for purposes of the reporting requirements under Section 13(d) of the Securities Exchange Act of 1934;

b. if the research analyst or a household member has a financial interest in the securities of the subject company, and the nature of the financial interest, including, without limitation, whether it consists of any option, right, warrant, futures contract, long or short position;

c. if, to the extent the research analyst knows or has reason to know:

1. the subject company currently is a client of the member or member organization or was a client of the member or member organization during the twelve (12)-month period preceding the date of the public appearance by the research analyst. In such instances, the research analyst also must disclose the types of services provided to the subject company (For purposes of this paragraph, the types of services provided to the subject company may be described as investment banking services, non-investment banking-securities related services, and non-securities services.);

2. the member or member organization or any affiliate thereof, received any compensation from the subject company in the past twelve (12) months.

d. any other actual, material conflict of interest of the research analyst, or member or member organization, of which the research analyst knows, or has reason to know, at the time the public appearance is made;

e. if the research analyst or a household member is an officer, director, or advisory board member of the subject company;

f. if the research analyst received any compensation from the subject company in the past twelve (12) months.

(k)(3) Exceptions to the Required Disclosures

(i) A member or member organization or a research analyst will not be required to make a disclosure required by Rule 472(k)(l)(i)a.2. and 3., (k)(1)(i)d.1., (k)(1)(ii)b.1., and (k)(2)(i)c. to the extent such disclosure would reveal material non-public information regarding specific potential future investment banking services transactions of the subject company.

Other Communications Activities

(l) Other communications activities are deemed to include, but are not limited to, conducting interviews with the media, writing books, conducting seminars or lecture courses, writing newspaper or magazine articles, or making radio/TV appearances.

Members and member organizations must establish specific written supervisory procedures applicable to members, allied members, and employees who engage in these types of communications activities. These procedures must include provisions that require prior approval of such activity by a person designated under the provisions of Rule 342(b)(1). These types of activities are subject to the general standards set forth in paragraph (i). In addition, any activity which includes discussion of specific securities is subject to the specific standards in paragraph (j).

Small Firm Exception

(m) The provisions of Rule 472(b)(1), (2) and (3) do not apply to members and member organizations that over the three previous years, on average per year, have participated in ten (10) or fewer investment banking services transactions as manager or co-manager and generated $5 million or less in gross investment banking services revenues from those transactions. For purposes of this paragraph, the term "investment banking services transactions" shall include both debt and equity underwritings but not municipal securities underwritings. Members and member organizations that qualify for this exemption must maintain records for three (3) years of any communications that, but for this exemption, would be subject to paragraphs (b)(1), (2), and (3) of this Rule.

• • • ***Supplementary Material:*** ------------------

.10 Definitions

(1) **Communication**—The term "Communication" is deemed to include, but is not limited to advertisements, market letters, research reports, sales literature, electronic communications, communications in and with the press and wires and memoranda to branch offices or correspondent firms which are shown or distributed to customers or the public.

(2) **Research Report**— "Research report" is generally defined as a written or electronic communication which includes an analysis of equity securities of individual companies or industries, and provides information reasonably sufficient upon which to base an investment decision.

For purposes of approval by a supervisory analyst pursuant to Rule 472 (a)(2), the term research report includes, but is not limited to, a report which recommends equity securities, derivatives of such securities, including options, debt and other types of fixed income securities, single stock futures products, and other investment vehicles subject to market risk.

(3) **Advertisement**— "Advertisement" is defined to include, but is not limited to, any sales communications that is published, or designed for

use in any print, electronic or other public media such as newspapers, periodicals, magazines, radio, television, telephone recording, web sites, motion pictures, audio or video device, telecommunications device, billboards or signs.

(4) **Market letters**— "Market letters" are defined as, but are not limited to, any written comments on market conditions, individual securities, or other investment vehicles that are not defined as research reports. They also may include "follow-ups" to research reports and articles prepared by members or member organizations which appear in newspapers and periodicals.

(5) **Sales literature**— "Sales literature" is defined as, but is not limited to, written or electronic communications including, but not limited to, telemarketing scripts, performance reports or summaries, form letters, seminar texts, and press releases discussing or promoting the products, services, and facilities offered by a member or member organization, the role of investment in an individual's overall financial plan, or other material calling attention to any other communication.

.20 For purposes of this Rule, "investment banking services" includes, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs (private investment, public equity transaction), or similar investments; or serving as placement agent for the issuer.

.30 For purposes of this Rule, the term "Investment Banking Department" means any department or division of the member or member organization, whether or not identified as such, that performs any investment banking services on behalf of the member or member organization.

.40 For purposes of this Rule, the term "research analyst" includes a member, allied member, associated person or employee of a member or member organization primarily responsible for, and any person who reports directly or indirectly to such research analyst in connection with, the preparation of the substance of a research report whether or not any such person has the job title of "research analyst".

For purposes of this Rule, the term "household member" means any individual whose principal residence is the same as the research analyst's principal residence. Paragraphs (e)(1), (2), (3), (4)(i), (ii), (iii), (iv) and (v), (k)(1)(iii)b., c., and (k)(2)(i)b. and e. apply to any account in which a research analyst has a financial interest, or over which the research analyst exercises discretion or control, other than an investment company registered under the Investment Company Act of 1940. The trading restrictions applicable to research analysts and household members (i.e., paragraphs (e)(1), (2), (3), (4)(i), (ii), (iii), (iv) and (v); do not apply to a "blind trust" account that is controlled by a person other than the research analyst or research analyst's household member where neither the research analyst nor household member knows of the account's investments or investment transactions.

.50 For purposes of this Rule, the term "public appearance" includes, without limitation, participation by a research analyst in a seminar, forum (including an interactive electronic forum), radio, television or print media interview, or public speaking activity, or the writing of a print media article in which such research analyst makes a recommendation or offers an opinion concerning any equity securities.

.60 For purposes of this Rule, "subject company" is the company whose equity securities are the subject of a research report or a public appearance.

.70 For purposes of Rule 472(k)(1)(i)(h), a member or member organization must determine, based on its own ratings system, into which of the three (3) categories each of their securities ratings utilized falls. This information must be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than fifteen (15) calendar days after the most recent calendar quarter). For example, a research report might disclose that the member or member organization has assigned a "buy" rating to 58% of the securities that it follows, a "hold" rating to 15%, and a "sell" rating to 27%.

Rule 472(k)(1)(i)h. requires members or member organizations to disclose the percentage of companies that are investment banking services clients for each of the three (3) ratings categories within the previous twelve (12) months. For example, if twenty (20) of the twenty-five (25) companies to which a member or member organization has assigned a "buy" rating are investment banking clients of the member or member organization, the member or member organization would have to disclose that 80% of the companies that received a "buy" rating are its investment banking clients. Such disclosure must be made for the "buy," "hold" and "sell" ratings categories as appropriate.

.80 For purposes of this Rule, the term "Legal or Compliance Department" also includes, but is not limited to, any department of the member or member organization which performs a similar function.

.90 For purposes of Rule 472(a)(1), a qualified person is one who has passed an examination acceptable to the Exchange.

.100 For purposes of this Rule, the term "initial public offering" refers to the initial registered equity security offering by an issuer, regardless of whether such issuer is subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, prior to the time of the filing of such issuer's registration statement.

.110 For purposes of this Rule, a secondary offering shall include a registered follow-on offering by an issuer or a registered offering by persons other than the issuer involving the distribution of securities subject to Regulation M of the Securities Exchange Act of 1934.

.120 For purposes of this Rule, the term "offering date" refers to the later of the effective date of the registration statement or the first date on which the security was bona fide offered to the public.

.130 For purposes of this Rule, the term associated person is defined as a natural person engaged in investment banking, or a securities or kindred business, who is directly or indirectly controlling or controlled by a member or member organization, whether or not any such person is registered, applying for registration or exempt from registration with the NYSE.

Amended: October 20, 1955, effective November 1, 1955; September 19, 1963, effective October 15, 1963; June 18, 1964; March 26, 1970; February 2, 1977; December 14, 1983; December 31, 1997; March 19, 1990; May 10, 2002 effective July 9, 2002 (NYSE-2002-09); July 29, 2003 (NYSE-2002-49); April 14, 2005 (NYSE-2005-24); April 21, 2005 (NYSE-2004-24).

Rule 472 COMMUNICATIONS WITH THE PUBLIC

(k)(2) Disclosure Required in Public Appearances

/01 Public Appearances – Print Media

When a research analyst recommends securities in a print or broadcast media interview, newspaper article or other type of public medium all of the disclosures required under Rule 472(k)(2) are required to be provided to the media outlet for inclusion in the published interview, article, broadcast, or other medium.

Whenever a research analyst recommends securities in a print media interview, newspaper article prepared under his or her name, or broadcast, a record of such interview, article or broadcast must be made within forty-eight (48) hours of such interview, article or broadcast. Such record must be prepared by the research analyst, Legal or Compliance personnel or Research Department management.

Such record must include, at minimum, the name of the research analyst(s), the name of the publication, the date of the interview, article, or broadcast the name of the interviewer (if applicable), the name(s) of the securities recommended and the specific disclosures provided to the print or broadcast media source and/or interviewer. Such record must be made regardless of whether the media outlet published or broadcast the required disclosures. The research analyst's member or member organization must retain the record of such interview, article, or broadcast and the disclosures made in a manner consistent with Rule 17a-4 of the Securities Exchange Act of 1934. The record retained must be readily available to the Exchange, upon request.

Rule 351. Reporting Requirements

(a) Each member not associated with a member organization and each member organization shall promptly report to the Exchange whenever such member or member organization, or any member, allied member or registered or non-registered employee associated with such member or member organization:

(1) has violated any provision of any securities law or regulation, or any agreement with or rule or standards of conduct of any governmental agency, self-regulatory organization, or business or professional organization, or engaged in conduct which is inconsistent with just and equitable principles of trade or detrimental to the interests or welfare of the Exchange;

(2) is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery;

(3) is named as a defendant or respondent in any proceeding brought by a regulatory or self-regulatory body alleging the violation of any provision of the Securities Exchange Act of 1934, or of any other Federal or state securities, insurance, or commodities statute, or of any rule or regulation thereunder, or of any agreement with, or of any provision of the constitution, rules or similar governing instruments of, any securities, insurance or commodities regulatory or self-regulatory organization;

(4) is denied registration or is expelled, enjoined, directed to cease and desist, suspended or otherwise disciplined by any securities, insurance or commodities industry regulatory or self-regulatory organization or is denied membership or continued membership in any such self-regulatory organization; or is barred from becoming associated with any member or member organization of any such self-regulatory organization;

(5) is arrested, arraigned, indicted or convicted of, or pleads guilty to, pleads no contest to, any felony; or any misdemeanor that involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or a conspiracy to commit any of these offenses, or substantially equivalent activity in a domestic, military or foreign court;

(6) is a director, controlling stockholder, partner, officer or sole proprietor of, or an associated person with, a broker, dealer, investment company, investment advisor, underwriter or insurance company which was suspended, expelled or had its registration denied or revoked by any agency, jurisdiction or organization or is associated in such a capacity with a bank, trust company or other financial institution which was convicted of, or pleaded no contest to, any felony or misdemeanor;

(7) is a defendant or respondent in any securities or commodities-related civil litigation or arbitration which has been disposed of by judgment, award or settlement for an amount exceeding $15,000. However, when a member organization is the defendant or respondent, then the reporting to the

Exchange shall be required only when such judgment, award or settlement is for an amount exceeding $25,000;

(8) is the subject of any claim for damages by a customer, broker or dealer which is settled for an amount exceeding $15,000. However, when the claim for damages is against a member organization, then the reporting to the Exchange shall be required only when such claim is settled for an amount exceeding $25,000;

(9) is, or learns that he is associated in any business or financial activity with any person who is, subject to a "statutory disqualification" as that term is defined in the Securities Exchange Act of 1934.

(10) is the subject of any disciplinary action taken by the member or member organization against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of $2,500, or any other significant limitation on activities.

(b) Each member associated with a member organization and each allied member or registered or non-registered employee of a member or member organization shall promptly report the existence of any of the conditions set forth in paragraph (a) of this rule to the member or member organization with which such person is associated.

(c) Each approved person shall promptly report to the member organization with which such approved person is associated, whenever such approved person becomes subject to a statutory disqualification as defined in the Securities Exchange Act of 1934; and upon being so notified, or otherwise learning such fact, the member or member organization shall promptly so advise the Exchange in writing, giving the name of the person subject to the statutory disqualification and details concerning the disqualification.

(d) At such intervals and in such detail as the Exchange shall specify, each member not associated with a member organization and each member organization shall report to the Exchange statistical information regarding customer complaints relating to such matters as may be specified by the Exchange. For the purpose of this paragraph (d), "customer" includes any person other than a broker or dealer.

(e) Each member not associated with a member organization and a senior officer or partner of each member organization shall take one or both of the following two actions in relation to the trades that are subject to the review procedures required by Rule 342.21(a):

(i) Sign a written statement in the form specified below and deliver it to the Exchange by the 15th day of the month following the calendar quarter in which the trade occurred, and

(ii) As to any such trade that is the subject of an internal investigation pursuant to Rule 342.21(b), but has not been both resolved and included in the written statement made pursuant to subparagraph (i) above, report in writing to the Exchange:

(A) The commencement of the internal investigation, the identity of the trade and the reason why the trade could not be the subject of a written statement made pursuant to subparagraph (i) above (report by the 15th day of the month, following the calendar quarter in which the trade occurred).

(B) The quarterly progress of each open investigation (report by the 15th day of the month following the quarter).

(C) The completion of the investigation, detailing the methodology and results of the investigation, any internal disciplinary action taken, and any referral of the matter to the Exchange, another self-regulatory organization, the Securities and Exchange Commission or another Federal agency; and including, where no internal disciplinary action has been taken and no such referral has been made, a written statement in relation to the trade in the form specified below (report within one week after completion of the investigation).

The statement that subparagraph (i) requires shall read substantially as follows:

(1) [I/NAME OF MEMBER ORGANIZATION] [have/has] established procedures for reviewing the facts and circumstances surrounding trades in NYSE listed securities and related financial instruments for [my/the] account [of NAME OF MEMBER ORGANIZATION] ("Proprietary Trades") and for the accounts of [my/its] [members, allied members and] employees and their family members, including trades reported by other members or member organizations pursuant to Rule 407, ("Employee Trades"), which procedures [I/NAME OF MEMBER ORGANIZATION] [have/has] determined to be reasonably designed to identify trades that may violate the provisions of the Securities Exchange Act of 1934, the rules under that act or the rules of the Exchange prohibiting insider trading and manipulative and deceptive devices,

(2) I, my designees or the senior supervisors responsible for particular activities have carried out those procedures in relation to Proprietary Trades and Employee Trades effected during the [ORDINAL NUMBER] quarter of [YEAR], and

(3) Based upon my assessment of the adequacy of those procedures and of the diligence of those carrying out those procedures, and except as to those Proprietary Trades and Employee Trades that I have reported to the Exchange pursuant to Rule 351(e)(ii) as the subject of internal investigation, I have no reasonable cause to believe that: (a) any one or more of the Proprietary Trades effected during the period referred to in clause (2) above, or (b) any one or more of the Employee Trades both effected during that period and reviewed under those procedures violated the provisions of the Securities Exchange Act of 1934, the rules under the act or the rules of the Exchange prohibiting insider trading and manipulative and deceptive devices.

When a statement pertains to one or more trades that have been the subject of an internal investigation pursuant to Rule 342.21(b) but as to which no internal disciplinary action has been taken and no referral of the matter to the Exchange, to another self-regulatory organization or to a Federal agency has been made, the statement that subparagraph (ii) (C) requires shall be as above, except that it shall refer to the particular trade (s) (rather than to the trades of a particular calendar quarter) and shall omit the clause excepting trades reported as the subject of an investigation. For the purpose of this paragraph (e), a "senior officer or partner" means (i) the chief executive officer or managing partner or

(ii) either (A) any other officer or partner who is a member of the member organization's executive or management committee or its equivalent committee or group or (B) if the member organization has no such committee or group, any officer or partner having senior executive or management responsibility who reports directly to the Chief Executive Officer or managing partner. If, in the case of a member organization, its chief executive officer or managing partner does not sign the statement, a copy of the statement shall be provided to the chief executive officer or managing partner.

(f) Each member and member organization that prepares, issues or distributes research reports or whose research analysts make public appearances is required to submit to the member's or member organization's Designated Examining Authority, annually, a letter of attestation signed by a senior officer or partner that the member or member organization has established and implemented procedures reasonably designed to comply with the provisions of Rule 472. The attestation must also specifically certify that each research analyst's compensation was reviewed and approved in accordance with the requirements of Rule 472(h)(2) and that the basis for such approval has been documented.

Amended: March 16, 1972; February 15, 1979; March 26, 1980; May 27, 1988; March 22, 1990; May 3, 2002; July 9, 2002 (2002-09); July 29, 2003 (NYSE-2002-49).

• • • ***Supplementary Material:*** ------------------

.10 Any report required pursuant to paragraphs (a), (b) or (d) of this Rule 351 shall be submitted to the Exchange on a form or forms prescribed by the Exchange.

Adopted: February 15, 1979.

Amended: May 27, 1988.

.11 For purposes of Rule 351(f), the attestation must be submitted by April 1 of each year.

Adopted: July 9, 2002 (2002-09).

.12 The term "research report" is defined in Rule 472.10 and the term "public appearance" is defined in Rule 472.50.

Adopted: July 9, 2002 (2002-09).

Amended: July 29, 2003 (NYSE-2002-49).

Rule 344. Research Analysts and Supervisory Analysts

Research analysts and supervisory analysts must be registered with, qualified by, and approved by the Exchange.

Adopted: June 18, 1964.

• • • ***Supplementary Material:*** ------------------

.10 For purposes of this Rule, the term "research analyst" includes a member, allied member, associated person or employee who is primarily responsible for the preparation of the substance of a research report and/or whose name appears on such report. Such research analysts must pass a qualification examination acceptable to the Exchange.

.11 For purposes of this Rule, the term "supervisory analyst" includes a member, allied member, or employee who is responsible for preparing or approving research reports under Rule 472(a)(2). In order to show evidence of acceptability to the Exchange as a supervisory analyst, a member, allied member, or employee may do one of the following:

(1) Present evidence of appropriate experience and pass an Exchange Supervisory Analyst Examination (Series 16).

(2) Present evidence of appropriate experience and successful completion of a specified level of the Chartered Financial Analysts Examination prescribed by the Exchange and pass only that portion of the Exchange Supervisory Analyst Examination (Series 16) dealing with Exchange rules on research standards and related matters.

The Exchange publishes a Study Outline for the Research Analyst Examination and the Supervisory Analyst Examination (Series 16).

.12 For purposes of this Rule, the term "associated person" is defined as a natural person engaged in investment banking, or a securities or kindred business, who is directly or indirectly controlling or controlled by a member or member organization, whether or not any such person is registered, applying for registration or exempt from registration with the NYSE.

Amended: October 4, 1973; March 10, 1983; July 29, 2003 (NYSE-2002-49); February 23, 2005 (NYSE-2005-12); April 14, 2005 (NYSE-2005-24).

Rule 344 RESEARCH ANALYSTS AND SUPERVISORY ANALYSTS

/01 Research Analysts

Qualifications

Research Analyst candidates shall qualify by taking the Research Analyst Qualification Examination (Series 86/87). For purposes of this interpretation, the term "research analyst" is defined in Rule 344.10. The Series 86 covers security analysis and valuation of equity securities. The Series 87 covers pertinent rules and regulations of the self-regulatory organizations, and the SEC.

Prerequisite

The General Securities Registered Representative Examination (Series 7) qualification is a prerequisite for any Research Analyst candidate prior to taking either Part I (Series 86) or Part II (Series 87) of the Research Analyst Qualification Examination.

Alternatively, the United Kingdom Limited Registered Representative (Series 17) Examination and the Canadian Limited Registered Representative (Series 37/38) Examination will also serve as prerequisites to taking either Part I or Part II of the Research Analyst Qualification Examination.

In satisfying the Series 7, Series 17 or Series 37/38 examination prerequisite, Research Analyst candidates will not be required to complete the four-month training period required of Registered Representative candidates nor do they have to be approved by the Exchange pursuant to Rule 345.15/02 (see page 3459).

Candidates that have failed either Part I or II of the Research Analyst Qualification Examination must wait 30 days before retaking either part of the examination.

Rule 344 RESEARCH ANALYSTS AND SUPERVISORY ANALYSTS

/01 Qualifications (continued)

Exemptions

Successful completion of Levels I and II of the Charter Financial Analyst ("CFA") Examination administered by the CFA Institute allows a Research Analyst candidate to request an exemption from Part I (Series 86) of the Research Analyst Qualification Examination. If an exemption is granted for Part I (Series 86), a candidate will be qualified as a Research Analyst after passing Part II (Series 87) and the prerequisite examination (i.e., Series 7, 17, or 37/38 examinations).

Successful completion of Levels I and II of the Chartered Market Technician Program ("CMT") administered by the Market Technician Association ("MTA") allows a Research Analyst candidate who prepares only technical research reports to request an exemption from Part I (Series 86) of the Research Analyst Qualification Examination. If an exemption is granted for Part I (Series 86), a candidate will be qualified as a Research Analyst only after passing Part II (Series 87) and the prerequisite examination (i.e., Series 7, 17, or 37/38 examinations).

To qualify for a CFA or CMT exemption a Research Analyst candidate must have: (i) completed the CFA Level II or CMT Level II within two years of application for registration or (ii) functioned as a research analyst continuously since having passed the CFA Level II or CMT Level II. Applicants that have completed the CFA Level II or CMT Level II that do not meet criteria (i) or (ii) may where good cause is shown based upon previous related employment experience make a written request to the Exchange for an exemption.

A technical research report is a research report as defined in Rule 472.10(2) that is based solely on stock price movement and trading volume and not on the subject company's financial information, business prospects, contact with the subject company's management, or the valuation of a subject company's securities.

Rule 344 RESEARCH ANALYSTS AND SUPERVISORY ANALYSTS

/02 Foreign Research Analysts

Exemption

The requirement that a research analyst as defined under NYSE Rule 344.10 must be registered with, qualified by and approved by the Exchange shall not apply where such analyst is an associated person of a member or member organization who is an employee of a non-member foreign affiliate of such member or member organization who contributes to the preparation of the member's or member organizations research reports ("foreign research analyst"), provided the following conditions are satisfied:

- The foreign research analyst resides and is employed in a jurisdiction that the NYSE has determined has registration and qualification requirements or other standards that reflect a recognition of principles that are consonant with NYSE Rule 344 and the research analyst conflicts of interest provisions pursuant to NYSE Rule 472;

- The foreign research analyst has satisfied all applicable registration and qualification requirements or other research-related standards in the jurisdictions in which the foreign research analyst resides and is employed;

- Members and member organizations have imposed on affiliates that employ foreign research analysts, and the foreign research analysts all research-related standards that the member or member organization imposes on its research reports and research analysts, including the provisions of NYSE Rule 472;

- Members, member organizations and their affiliates that distribute research reports partially or entirely prepared by a foreign research analyst must subject such research reports to pre-use review and approval by a supervisory analyst, as required by NYSE Rule 472;

Rule 344 RESEARCH ANALYSTS AND SUPERVISORY ANALYSTS

/02 Foreign Research Analysts (continued)

- The annual attestation required under NYSE Rule 351(f) must include the global application of NYSE Rule 472 to foreign affiliates that employ foreign research analysts; and

- In addition to the disclosure requirements of NYSE Rule 472, each research report must include a disclosure on the front page stating that:

  "This research report has been prepared in whole or part by foreign research analysts who may be associated persons of the member or member organization. These research analysts are not registered/qualified as a research analyst with the NYSE and/or NASD, but instead have satisfied the registration/qualification requirements or other research-related standards of a foreign jurisdiction that have been recognized for these purposes by the NYSE and NASD."

Disclosure on the front page of each research report must identify:

(1) each affiliate contributing to the research report;
(2) the location of such affiliate; and
(3) the names of the foreign research analysts employed by each contributing affiliate.

The cover page must also contain general disclosure language describing the relationship between the contributing affiliates and the member or member organization.

NYSE Rule 344/02

Rule 344 RESEARCH ANALYSTS AND SUPERVISORY ANALYSTS

/02 Foreign Research Analysts (continued)

The front page of the research report must also refer to a separate "Foreign Affiliate Disclosures" section (similar to the "Required Disclosure" section currently mandated by the NYSE and NASD under Rules 472 and 2711 respectively) located in close proximity to the "Required Disclosure" section.

In this disclosure section, the member or member organization must disclose the following:

(1) information on the nature of the affiliation with the affiliate;
(2) each affiliate's address; and
(3) the primary regulator in the jurisdiction(s) in which each affiliate is located.

Record Keeping

Members and member organization must establish and maintain records that identify those individuals who have availed themselves of this exemption, the basis for such exemption, and evidence of compliance with the conditions of the exemption.

/03 Supervisory Analysts

Qualifications

Supervisory Analyst candidates shall qualify by taking and passing the Supervisory Analyst (Series 16) Examination.

Rule 344 RESEARCH ANALYSTS AND SUPERVISORY ANALYSTS

/03 Supervisory Analysts (continued)

Qualifications (continued)

Experience

Appropriate experience for a candidate for Supervisory Analyst means having at least three years prior experience within the immediately preceding six years involving securities or financial analysis.

Examples of appropriate experience may include the following:

- Equity or Fixed Income Research Analyst;
- Credit Analyst for a securities rating agency;
- Supervising preparation of materials prepared by financial/securities analysts;
- Financial analytical experience gained at banks, insurance companies or other financial institutions;
- Academic experience relating to the financial/securities markets/industry.

Director of Research

A person having the title of "Director of Research" need not be a supervisory analyst as defined by the Rule so long as he/she does not approve research reports. If, however, such a person is in charge of registered representatives, he/she must qualify as a supervisory person under Rule 342.13.

/04 Exemptions

Successful completion of the CFA Level I Examination administered by the CFA Institute (in lieu of completion of Levels, I, II and III for a full CFA designation) will suffice to allow a Supervisory Analyst candidate to qualify by taking Part I of the Series 16 Qualification Examination.

(Next Page No. is 3450)

Rule 345A. Continuing Education For Registered Persons

(a) **Regulatory Element**—No member or member organization shall permit any registered person to continue to, and no registered person shall continue to, perform duties as a registered person, unless such person has complied with the continuing education requirements of Section (a) of this Rule.

(1) Each registered person shall complete the Regulatory Element of the continuing education program on the occurrence of their second registration anniversary date and every three years thereafter or as otherwise prescribed by the Exchange. On each occasion, the Regulatory Element must be completed within one hundred twenty days after the person's registration anniversary date. A person's initial registration date, also known as the "base date", shall establish the cycle of anniversary dates for purposes of this Rule. The content of the Regulatory Element of the program shall be determined by the Exchange for each registration category of persons subject to the rule.

(2) **Failure to complete**—Unless otherwise determined by the Exchange, any registered persons who have not completed the Regulatory Element of the program within the prescribed time frames will have their registration deemed inactive until such time as the requirements of the program have been satisfied. Any person whose registration has been deemed inactive under this Rule shall cease all activities as a registered person and is prohibited from performing any duties and functioning in any capacity requiring registration. The Exchange may, upon application and a showing of good cause, allow for additional time for a registered person to satisfy the program requirements.

(3) **Disciplinary Actions**—Unless otherwise determined by the Exchange, a registered person will be required to re-take the Regulatory Element of the program and satisfy the program's requirements in their entirety in the event such person:

(i) becomes subject to any statutory disqualification as defined in Section 3(a)(39) of the Securities Exchange Act of 1934 (see also Rule 346(f));

(ii) becomes subject to suspension or to the imposition of a fine of $5,000 or more for violation of any provision of any securities law or regulation, or any agreement with or rule or standard of conduct of any securities governmental agency, securities self-regulatory organization, or as imposed by any such regulatory or self-regulatory organization in connection with a disciplinary proceeding; or

(iii) is ordered pursuant to a disciplinary proceeding to re-take the Regulatory Element by any securities governmental agency or securities self-regulatory organization.

A re-taking of the Regulatory Element shall commence with participation within one hundred twenty days of the registered person becoming subject to the statutory disqualification, in the case of (i) above, or the completion of the sanction or the disciplinary action becoming final, in the case of (ii) and (iii) above. The date that the disciplinary action becomes final will be deemed the person's new base date for purposes of this Rule.

(b) **Firm Element**

(1) **Persons Subject to the Firm Element**—The requirements of Section (b) of this Rule shall apply to any registered person who has direct contact with customers in the conduct of the member's or member organization's securities sales, trading or investment banking activities, and to the immediate supervisors of such persons, and to registered persons who function as supervisory analysts, and research analysts as defined in Rule 344 (collectively, "covered registered persons").

(2) **Standards**

(i) Each member and member organization must maintain a continuing and current education program for its covered registered persons to enhance their securities knowledge, skills and professionalism. At a minimum, each member and member organization shall at least annually evaluate and prioritize its training needs and develop a written training plan. The plan must take into consideration the member's or member organization's size, organizational structure, and scope of business activities, as well as regulatory developments and the performance of covered registered persons in the Regulatory Element. If a member's or member organization's analysis determines a need for supervisory training for persons with supervisory responsibilities, such training must be included in the member's or member organizations's training plan.

(ii) **Minimum Standards for Training Programs**—Programs used to implement a member's or member organization's training plan must be appropriate for the business of the member or member organization and, at a minimum, must cover the following matters concerning securities products, services and strategies offered by the member or member organization:

a. General investment features and associated risk factors;

b. Suitability and sales practice considerations; and

c. Applicable regulatory requirements.

(iii) **Administration of Continuing Education Program**—Each member and member organization must administer its continuing education program in accordance with its annual evaluation and written plan and must maintain records documenting the content of the programs and completion of the programs by covered registered persons.

(3) **Participation in the Firm Element**—Covered registered persons included in a member's or member organization's plan must take all appropriate and reasonable steps to participate in continuing education programs as required by the member or member organization.

(4) **Specific Training Requirements**—The Exchange may require a member or member organization, either individually or as part of a larger group, to provide specific training to its covered registered persons in such areas the Exchange deems appropriate. Such a requirement may stipulate the class of covered registered persons for which it is applicable, the time period in which the requirement must be satisfied and, where appropriate, the actual training content.

Amendments. March 3, 1998; July 29, 2003 (NYSE-2002-49); September 16, 2004 (SR-NYSE-2004-33)

• • • ***Supplementary Material:*** ------------------

.10 For purposes of this Rule, the term "registered person" means any member, allied member, registered representative, or other person registered or required to be registered under Exchange rules, but does not include any such person whose activities are limited solely to the transaction of business on the Floor with members or registered broker-dealers.

.20 For purposes of this Rule, the term "customer" means any natural person or any organization, other than a registered broker or dealer, executing transactions in securities or other similar instruments with or through, or receiving investment banking services from, a member or member organization.

.30 Any registered person who has terminated association with a registered broker or dealer and who has, within two years of the date of termination, become reassociated in a registered capacity with a registered broker or dealer shall participate in the Regulatory Element of the continuing education program at such intervals that apply (second registration anniversary and every three years thereafter) based on the initial registration anniversary date, rather than based on the date of reassociation in a registered capacity.

Any former registered person who becomes reassociated in a registered capacity with a registered broker or dealer more than two years after termination as such will be required to satisfy the program's requirements in their entirety (second registration anniversary and every three years thereafter), based on the most recent registration date.

Amendment. March 3, 1998.

.40 Any registration that is deemed inactive for a period of two calendar years pursuant to section (a)(2) of this Rule for failure of a registered person to complete the Regulatory Element, shall be terminated. A person whose registration is so terminated may become registered only by reapplying for registration and satisfying applicable registration and qualification requirements of Exchange rules (see Rule 345).

Adopted. January 30, 1995.

.50 Pursuant to Rule 345A(b)(1), all persons registered as research analysts and supervisory analysts pursuant to Rule 344 must participate in a Firm Element Continuing Education program that includes training in applicable rules and regulations, ethics, and professional responsibility.

Adopted. July 29, 2003 (NYSE-2002-49).

NASD Manual

2711. Research Analysts and Research Reports

***NASD members must implement the provisions of Rule 2711 no later than Tuesday, July 9, 2002, except for those sections which indicate a different implementation date below ***

(a) Definitions

For purposes of this rule, the following terms shall be defined as provided.

(1) "Investment banking department" means any department or division, whether or not identified as such, that performs any investment banking service on behalf of a member.

(2) "Investment banking services" include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs or similar investments; or serving as placement agent for the issuer.

(3) "Member of a research analyst's household" means any individual whose principal residence is the same as the research analyst's principal residence.

(4) "Public appearance" means any participation in a seminar, forum (including an interactive electronic forum), radio, television or print media interview, or other public speaking activity , or the writing of a print media article, in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

(5) "Research analyst" means the associated person who is primarily responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of "research analyst."

(6) "Research analyst account" means any account in which a research analyst or member of the research analyst's household has a financial interest, or over which such analyst has discretion or control, other than an investment company registered under the Investment Company Act of 1940.This term does not include a "blind trust" account that is controlled by a person other than the research analyst or member of the research analyst's household where neither the research analyst nor a member of the research analyst's household knows of the account's investments or investment transactions.

(7) "Research department" means any department or division, whether or not identified as such, that is principally responsible for preparing the substance of a research report on behalf of a member.

(8) "Research Report" means a written or 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.

(9) "Subject company" means the company whose equity securities are the subject of a research report or a public appearance.

(b) Restrictions on Relationship with Research Department

(1) No research analyst may be subject to the supervision or control of any employee of the member's investment banking department, and no personnel engaged in investment banking activities may have any influence or control over the compensatory evaluation of a research analyst.

(2) Except as provided in paragraph (b)(3), no employee of the investment banking department or any other employee of the member who is not directly responsible for investment research ("non-research personnel"), other than legal or compliance personnel, may review or approve a research report of the member before its publication.

(3) Non-research personnel may review a research report before its publication as necessary only to verify the factual accuracy of information in the research report or identify any potential conflict of interest, provided that:

(A) any written communication between non-research personnel and research department personnel concerning the content of a research report must be made either through authorized legal or compliance personnel of the member or in a transmission copied to such personnel; and

(B) any oral communication between non-research personnel and research department personnel concerning the content of a research report must be documented and made either through authorized legal or compliance personnel acting as intermediary or in a conversation conducted in the presence of such personnel.

(c) Restrictions on Communications with the Subject Company

(1) Except as provided in paragraphs (c)(2) and (c)(3), a member may not submit a research report to the subject company before its publication.

(2) A member may submit sections of such a research report to the subject company before its publication for review as necessary only to verify the factual accuracy of information in those sections, provided that:

(A) the sections of the research report submitted to the subject company do not contain the research summary, the research rating or the price target;

(B) a complete draft of the research report is provided to legal or compliance personnel before sections of the report are submitted to the subject company; and

(C) if after submitting the sections of the research report to the subject company the research department intends to change the proposed rating or price target, it must first provide written justification to, and receive written authorization from, legal or compliance personnel for the change. The member must retain copies of any draft and the final version of such a research report for three years following its publication.

**** NASD members must implement the provisions of Rule 2711(c)(2) no later than Wednesday, September 9, 2002****

(3) The member may notify a subject company that the member intends to change its rating of the subject company's securities, provided that the notification occurs on the business day before the member announces the rating change, after the close of trading in the principal market of the subject company's securities.

(4) No research analyst may participate in efforts to solicit investment banking business. Accordingly, no research analyst may, among other things, participate in any "pitches" for investment banking business to prospective investment banking clients, or have other communications with companies for the purpose of soliciting investment banking business.

(5) A research analyst is prohibited from directly or indirectly:

(A) participating in a road show related to an investment banking services transaction; and

(B) engaging in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction.

(6) Investment banking department personnel are prohibited from directly or indirectly:

(A) directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction; and

(B) directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction.

(7) Any written or oral communication by a research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

(d) Restrictions on Research Analyst Compensation

(1) No member may pay any bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services transaction.

(2) The compensation of a research analyst who is primarily responsible for the preparation of the substance of a research report must be reviewed and approved at least annually by a committee that reports to the member's board of directors, or when the member has no board of directors, to a senior executive officer of the member. This committee may not have representation from the member's investment banking department. The committee must consider the following factors when reviewing such a research analyst's compensation, if applicable:

***** NASD members must implement the following provisions of Rule 2711(d)(2) no later than October 27, 2003****

(A) the research analyst's individual performance, including the analyst's productivity and the quality of the analyst's research;

(B) the correlation between the research analyst's recommendations and the stock price performance; and

(C) the overall ratings received from clients, sales force, and peers independent of the member's investment banking department, and other independent ratings services.

The committee may not consider as a factor in reviewing and approving such a research analyst's compensation his or her contributions to the member's investment banking business. The committee must document the basis upon which each such research analyst's compensation was established. The annual attestation required by Rule 2711(i) must certify that the committee reviewed and approved each such research analyst's compensation and documented the basis upon which this compensation was established.

(e) Prohibition of Promise of Favorable Research

No member may directly or indirectly offer favorable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.

(f) Restrictions on Publishing Research Reports and Public Appearances; Termination of Coverage

(1) No member may publish or otherwise distribute a research report and no research analyst may make a public appearance regarding a subject company for which the member acted as manager or co-manager of:

(A) an initial public offering, for 40 calendar days following the date of the offering; or

(B) a secondary offering, for 10 calendar days following the date of the offering; provided that:

(i) paragraphs (f)(1)(A) and (f)(1)(B) will not prevent a member from publishing or otherwise distributing a research report, or prevent a research analyst from making a public appearance, concerning the effects of significant news or a significant event on the subject company within such 40- and 10-day periods, and provided further that legal or compliance personnel authorize publication of that research report before it is issued or authorize the public appearance before it is made; and

(ii) paragraph (f)(1)(B) will not prevent a member from publishing or otherwise distributing a research report pursuant to SEC Rule 139 regarding a subject company with "actively-traded securities," as defined in Regulation M, 17 CFR 242.101(c)(1), and will not prevent a research analyst from making a public appearance concerning such a company.

(2) No member that has agreed to participate or is participating as an underwriter or dealer (other than as manager or co-manager) of an issuer's initial public offering may publish or otherwise distribute a research report or make a public appearance regarding that issuer for 25 calendar days after the date of the offering.

(3) For purposes of paragraphs (f)(1) and (f)(2), the term "date of the offering" refers to the later of the effective date of the registration statement or the first date on which the security was bona fide offered to the public.

(4) No member that has acted as a manager or co-manager of a securities offering may publish or otherwise distribute a research report or make a public appearance concerning a subject company 15 days prior to and after the expiration, waiver or termination of a lock-up agreement or any other agreement that the member has entered into with a subject company or its shareholders that restricts or prohibits the sale of securities held by the subject company or its shareholders after the completion of a securities offering. This paragraph will not prevent a member from publishing or otherwise distributing a research report concerning the effects of significant news or a significant event on the subject company within such period, provided legal or compliance personnel authorize publication of that research report before it is issued. In addition, this paragraph shall not apply to the publication or distribution of a research report pursuant to SEC Rule 139 regarding a subject company with "actively traded securities," as defined in Regulation M, 17 CFR 242.101(c)(1), or to a public appearance concerning such a subject company.

(5) If a member intends to terminate its research coverage of a subject company, notice of this termination must be made. The member must make available a final research report on the subject company using the means of dissemination equivalent to those it ordinarily uses to provide the customer with its research reports on the subject company. The report must be comparable in scope and detail to prior research reports and must include a final recommendation or rating, unless it is impracticable for the member to produce a comparable report (e.g., if the research analyst covering the subject company or sector has left the member or if the member terminates coverage of the industry or sector). If it is impracticable to produce a final recommendation or rating, the final research report must disclose the member's rationale for the decision to terminate coverage.

(g) Restrictions on Personal Trading by Research Analysts

(1) No research analyst account may purchase or receive any securities before the issuer's initial public offering if the issuer is principally engaged in the same types of business as companies that the research analyst follows.

(2) No research analyst account may purchase or sell any security issued by a company that the research analyst follows, or any option on or derivative of such security, for a period beginning 30 calendar days before and ending five calendar days after the publication of a research report concerning the company or a change in a rating or price target of the company's securities; provided that:

(A) a member may permit a research analyst account to sell securities held by the account that are issued by a company that the research analyst follows, within 30 calendar days after the research analyst began following the company for the member;

(B) a member may permit a research analyst account to purchase or sell any security issued by a subject company within 30 calendar days before the publication of a research report or change in the rating or price target of the subject company's securities due to significant news or a significant event concerning the subject company, provided that legal or compliance personnel pre-approve the research report and any change in the rating or price target.

(3) No research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the member.

(4) Legal or compliance personnel may authorize a transaction otherwise prohibited by paragraphs (g)(2) and (g)(3) based upon an unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account, provided that:

(A) legal or compliance personnel authorize the transaction before it is entered;

(B) each exception is granted in compliance with policies and procedures adopted by the member that are reasonably designed to ensure that these transactions do not create a conflict of interest between the professional responsibilities of the research analyst and the personal trading activities of a research analyst account; and

(C) the member maintains written records concerning each transaction and the justification for permitting the transaction for three years following the date on which the transaction is approved.

(5) The prohibitions in paragraphs (g)(1) through (g)(3) do not apply to a purchase or sale of the securities of:

(A) any registered diversified investment company as defined under Section (5)(b)(1) of the Investment Company Act of 1940; or

(B) any other investment fund over which neither the research analyst nor a member of the research analyst's household has any investment discretion or control, provided that:

(i) the research analyst accounts collectively own interests representing no more than 1% of the assets of the fund;

(ii) the fund invests no more than 20% of its assets in securities of issuers principally engaged in the same types of business as companies that the research analyst follows; and

(iii) if the investment fund distributes securities in kind to the research analyst or household member before the issuer's initial public offering, the research analyst or household member must either divest those securities immediately or the research analyst must refrain from participating in the preparation of research reports concerning that issuer.

(6) Legal or compliance personnel of the member shall pre-approve all transactions of persons who oversee research analysts to the extent such transactions involve equity securities of subject companies covered by the research analysts that they oversee. This pre-approval requirement shall apply to all persons, such as the director of research, supervisory analyst, or member of a committee, who have direct influence or control with respect to the preparation of the substance of research reports or establishing or changing a rating or price target of a subject company's equity securities.

(h) Disclosure Requirements

(1) Ownership and Material Conflicts of Interest

A member must disclose in research reports and a research analyst must disclose in public appearances:

(A) if the research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position);

(B) if, as of the end of the month immediately preceding the date of publication of the research report or the public appearance (or the end of the second most recent month if the publication date is less than 10 calendar days after the end of the most recent month), the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. Computation of beneficial ownership of securities must be based upon the same standards used to compute ownership for purposes of the reporting requirements under Section 13(d) of the Securities Exchange Act of 1934;

***NASD members must implement the provisions of Rule 2711(h)(1)(B) no later than Wednesday, November 6, 2002 ***

(C) any other actual, material conflict of interest of the research analyst or member of which the research analyst knows or has reason to know at the time of publication of the research report or at the time of the public appearance.

(2) Receipt of Compensation

**** NASD members must implement the new compensation and client disclosure provisions of Rule 2711(h)(2) no sooner than January 26, 2004 ****

(A) A member must disclose in research reports:

(i) if the research analyst received compensation:

a. based upon (among other factors) the member's investment banking revenues; or

b. from the subject company in the past 12 months.

(ii) the member or affiliate:

a. managed or co-managed a public offering of securities for the subject company in the past 12 months;

b. received compensation for investment banking services from the subject company in the past 12 months; or

c. expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months.

(iii) if (1) as of the end of the month immediately preceding the date of publication of the research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month) or (2) to the extent the research analyst or an employee of the member with the ability to influence the substance of the research knows:

a. the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months; or

b. the subject company currently is, or during the 12-month period preceding the date of distribution of the research report was, a client of the member. In such cases, the member also must disclose the types of services provided to the subject company. For purposes of this Rule 2711(h)(2), the types of services provided to the subject company shall be described as investment banking services, non-investment banking securities-related services, and non-securities services.

(iv) if, to the extent the research analyst or an employee of the member with the ability to influence the substance of the research report knows an affiliate of the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months.

(v) if, to the extent the research analyst or member has reason to know, an affiliate of the member received any compensation for products or services other than investment banking services from the subject company in the past 12 months.

a. This requirement will be deemed satisfied if such compensation is disclosed in research reports within 30 days after completion of the last calendar quarter, provided that the member has taken steps reasonably designed to identify any such compensation during that calendar quarter. This requirement shall not apply to any subject company as to which the member initiated coverage since the beginning of the current calendar quarter.

b. The research analyst and the member will be presumed not to have reason to know whether an affiliate received any compensation for products or services other than investment banking services from the subject company in the past 12 months if the member maintains and enforces policies and procedures reasonably designed to prevent the research analysts and employees of the member with the ability to influence the substance of research reports from, directly or indirectly, receiving information from the affiliate concerning whether the affiliate received such compensation.

(vi) For the purposes of this Rule 2711(h)(2), an employee of the member with the ability to influence the substance of the research report is an employee who, in the ordinary course of that person's duties, has the authority to review the particular research report and to change that research report prior to publication.

(B) A research analyst must disclose in public appearances:

(i) if, to the extent the research analyst knows or has reason to know, the member or any affiliate received any compensation from the subject company in the past 12 months;

(ii) if the research analyst received any compensation from the subject company in the past 12 months; or

(iii) if, to the extent the research analyst knows or has reason to know, the subject company currently is, or during the 12-month period preceding the date of distribution of the research report, was, a client of the member. In such cases, the research analyst also must disclose the types of services provided to the subject company, if known by the research analyst.

(C) A member or research analyst will not be required to make a disclosure required by paragraphs (h)(2)(A)(ii)(b) and (c), (h)(2)(A)(iii)(b), or (h)(2)(B)(i) and (iii) to the extent such disclosure would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.

**** NASD members must implement the provisions of Rule 2711(h)(2)(C) as they apply to disclosures under Rules 2711(h)(2)(A)(ii)(b) and (c) no later than July 29, 2003, and as they apply to disclosures under Rule 2711(h)(2)(A)(iii)(b), (h)(2)(B)(i) and (iii) by Jan. 26, 2004 ****

(3) Position as Officer or Director

A member must disclose in research reports and a research analyst must disclose in public appearances if the research analyst or a member of the research analyst's household serves as an officer, director or advisory board member of the subject company.

(4) Meaning of Ratings

A member must define in its research reports the meaning of each rating used by the member in its rating system. The definition of each rating must be consistent with its plain meaning.

(5) Distribution of Ratings

(A) Regardless of the rating system that a member employs, a member must disclose in each research report the percentage of all securities rated by the member to which the member would assign a "buy," "hold/neutral," or "sell" rating.

(B) In each research report, the member must disclose the percentage of subject companies within each of these three categories for whom the member has provided investment banking services within the previous twelve months.

(C) The information that is disclosed under paragraphs (h)(5)(A) and (h)(5)(B) must be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

***NASD members must implement the provisions of Rule 2711(h)(5) no later than Wednesday, September 9, 2002 ***

(6) Price Chart

A member must present in any research report concerning an equity security on which the member has assigned any rating for at least one year, a line graph of the security's daily closing prices for the period that the member has assigned any rating or for a three-year period, whichever is shorter. The line graph must:

(A) indicate the dates on which the member assigned or changed each rating or price target;

(B) depict each rating and price target assigned or changed on those dates; and

(C) be current as of the end of the most recent calendar quarter (or the second most recent calendar quarter if the publication date is less than 15 calendar days after the most recent calendar quarter).

***NASD members must implement the provisions of Rule 2711(h)(6) no later than Wednesday, September 9, 2002 ***

(7) Price Targets

A member must disclose in research reports the valuation methods used to determine a price target. Price targets must have a reasonable basis and must be accompanied by a disclosure concerning the risks that may impede achievement of the price target.

(8) Market Making

A member must disclose in research reports if it was making a market in the subject company's securities at the time that the research report was published.

(9) Disclosure Required by Other Provisions

In addition to the disclosure required by this rule, members and research analysts must provide disclosure in research reports and public appearances that is required by applicable law or regulation, including NASD Rule 2210 and the antifraud provisions of the federal securities laws.

(10) Prominence of Disclosure

The disclosures required by this paragraph (h) must be presented on the front page of research reports or the front page must refer to the page on which disclosures are found. Disclosures and references to disclosures must be clear, comprehensive and prominent.

(11) Disclosures in Research Reports Covering Six or More Companies

When a member distributes a research report covering six or more subject companies, for purposes of the disclosures required in paragraph (h), such research report may direct the reader in a clear manner as to where they may obtain applicable current disclosures in written or electronic format.

(12) Records of Public Appearances

Members must maintain records of public appearances by research analysts sufficient to demonstrate compliance by those research analysts with the applicable disclosure requirements under paragraph (h) of this Rule. Such records must be maintained for three years from the date of the public appearance.

**** NASD members must implement the provisions of Rule 2711(h)(12) no later than Sept. 29, 2003****

(i) Supervisory Procedures

Each member subject to this rule must adopt and implement written supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of this rule (including the attestation requirements of Rule 2711(d)(2)), and a senior officer of such a member must attest annually to NASD by April 1 of each year that it has adopted and implemented those procedures.

****NASD members must implement the provisions of Rule 2711(i) in accordance with the implementation schedule for Rule 2711 ****

(j) Prohibition of Retaliation Against Research Analysts

No member and no employee of a member who is involved with the member's investment banking activities may, directly or indirectly, retaliate against or threaten to retaliate against any research analyst employed by the member or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the member's present or prospective investment banking relationship with the subject company of a research report. This prohibition shall not limit a member's authority to discipline or terminate a research analyst, in accordance with the member's policies and procedures, for any cause other than the writing of such an unfavorable research report or the making of such an unfavorable public appearance.

**** NASD members must implement the provisions of Rule 2711(j) no later than July 29, 2003****

(k) Exceptions for Small Firms

**** NASD members must implement the provisions of Rule 2711(k) no later than July 29, 2003****

The provisions of paragraph (b) shall not apply to members that over 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 services revenues from those transactions. For purposes of this paragraph (k), the term "investment banking services transactions" includes the underwriting of both corporate debt and equity securities but not municipal securities. Members that qualify for this exemption must maintain records for three years of any communication that, but for this exemption, would be subject to paragraph (b) of this Rule.

Amended by SR-NASD-2004-141 eff. June 6, 2005.
Amended by SR-NASD-2004-003 eff. April 26, 2004.
Amended by SR-NASD-2002-154 eff. July 29, 2003.
Amended by SR-NASD-2002-74 eff. June 4, 2002.
Adopted by SR-NASD-2002-21 eff. April 24, 2002.

Selected Notices to Members: 02-39, 03-44, 05-34.

NASD Manual

1050. Registration of Research Analysts

(a) All persons associated with a member who are to function as research analysts shall be registered with NASD. Before registration as a Research Analyst can become effective, an applicant shall:

(1) be registered pursuant to Rule 1032 as a General Securities Representative; and

(2) pass a Qualification Examination for Research Analysts as specified by the Board of Governors.

(b) For the purposes of this Rule 1050, "research analyst" shall mean an associated person who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report.

(c) Upon written request pursuant to the Rule 9600 Series, NASD will grant a waiver from the analytical portion of the Research Analyst Qualification Examination (Series 86) upon verification that the applicant has passed:

(1) Levels I and II of the Chartered Financial Analyst ("CFA") Examination; or

(2) if the applicant functions as a research analyst who prepares only technical research reports as defined in paragraph (e), Levels I and II of the Chartered Market Technician ("CMT") Examination; and

(3) has either functioned as a research analyst continuously since having passed the Level II CFA or CMT examination or applied for registration as a research analyst within two years of having passed the Level II CFA or CMT examination.

(d) An applicant who has been granted an exemption pursuant to paragraph (c) still must become registered as a General Securities Representative and then complete the regulatory portion of the Research Analyst Qualification Examination (Series 87) before that applicant can be registered as a Research Analyst.

(e) For the purposes of paragraph (c)(2), a "technical research report" shall mean a research report, as that term is defined in Rule 2711(a)(8), that is based solely on stock price movement and trading volume and not on the subject company's financial information, business prospects, contact with subject company's management, or the valuation of a subject company's securities.

(f) The requirements of paragraph (a) shall not apply to an associated person who is an employee of a non-member foreign affiliate who contributes to the preparation of a member's research report ("foreign research analyst"), provided the following conditions are met:

(1) the foreign research analyst resides and is employed in a jurisdiction that NASD has determined has registration and qualification requirements or other standards that reflect a recognition of principles that are consonant with this rule and the research analyst conflict of interest rules pursuant to Rule 2711;

(2) the foreign research analyst has satisfied all applicable registration and qualification requirements or other research-related standards in the jurisdiction in which the foreign research analyst resides and is employed;

(3) the NASD member ("U.S. member") whose research reports a foreign research analyst contributes in the preparation of has imposed on its affiliates and the foreign research analysts they employ all of the provisions of Rule 2711 and all other research-related standards the member imposes on its own research reports and research analysts;

(4) the annual compliance attestation submitted by the U.S. member pursuant to Rule 2711(i) must encompass the global application of Rule 2711 to the U.S. member's foreign affiliates that participate in the preparation of the U.S. member's research reports;

(5) all U.S. member research reports to which a foreign research analyst contributes in the preparation must be approved by a properly registered principal or supervisory analyst pursuant to Rule 1022; and

(6) in addition to the disclosure requirements of Rule 2711, each U.S. member research report to which a foreign research analyst contributes in the preparation shall include the following on the front page:

(A) a statement that:

> "This research report has been prepared in whole or part by foreign research analysts who may be associated persons of the member or member organization. These research analysts are not registered/qualified as a research analyst with the NYSE and/or NASD, but instead have satisfied the registration/qualification requirements or other research-related standards of a foreign jurisdiction that have been recognized for these purposes by the NYSE and NASD."

(B) disclosures identifying each affiliate contributing to the research report, the location of such affiliate, and the names of the research analysts employed by the affiliate that contributed to the preparation of the research report;

(C) a general description of the relationship between the contributing affiliates and the U.S. member; and

(D) a reference to the page on which a separate "Foreign Affiliate Disclosures" section can be found. Such section shall disclose information on the nature of the affiliation between the entities, the affiliates' addresses, and the primary regulator in the jurisdiction(s) in which each affiliated entity is located.

(7) Members must establish and maintain records that identify those individuals who have availed themselves of the exemption in paragraph (f), specify the basis for such exemption, and evidence compliance with the conditions of paragraph (f).

Amended by SR-NASD-2005-043 eff. April 1, 2005.
Amended by SR-NASD-2005-022 eff. Feb. 4, 2005.
Amended by SR-NASD-2004-020 eff. March 30, 2004.
Amended by SR-NASD-2004-010 eff. Jan. 16, 2004.
Adopted by SR-NASD-2002-154 eff. July 29, 2003.

Selected Notice to Members: 03-44.

NASD Manual

1120. Continuing Education Requirements

This Rule prescribes requirements regarding the continuing education of certain registered persons subsequent to their initial qualification and registration with NASD. The requirements shall consist of a Regulatory Element and a Firm Element as set forth below.

(a) Regulatory Element

(1) Requirements

No member shall permit any registered person to continue to, and no registered person shall continue to, perform duties as a registered person unless such person has complied with the requirements of paragraph (a) hereof.

Each registered person shall complete the Regulatory Element on the occurrence of their second registration anniversary date and every three years thereafter, or as otherwise prescribed by NASD. On each occasion, the Regulatory Element must be completed within 120 days after the person's registration anniversary date. A person's initial registration date, also known as the "base date," shall establish the cycle of anniversary dates for purposes of this Rule. The content of the Regulatory Element shall be determined by NASD and shall be appropriate to either the registered representative or principal status of person subject to the Rule.

(2) Failure to Complete

Unless otherwise determined by the Association, any registered persons who have not completed the Regulatory Element within the prescribed time frames will have their registrations deemed inactive until such time as the requirements of the program have been satisfied. Any person whose registration has been deemed inactive under this Rule shall cease all activities as a registered person and is prohibited from performing any duties and functioning in any capacity requiring registration. A registration that is inactive for a period of two years will be administratively terminated. A person whose registration is so terminated may reactivate the registration only by reapplying for registration and meeting the qualification requirements of the applicable provisions of the Rule 1020 Series and the Rule 1030 Series. The Association may, upon application and a showing of good cause, allow for additional time for a registered person to satisfy the program requirements.

(3) Disciplinary Actions

Unless otherwise determined by NASD, a registered person will be required to retake the Regulatory Element and satisfy all of its requirements in the event such person:

(A) is subject to any statutory disqualification as defined in Section 3(a)(39) of the Act;

(B) is subject to suspension or to the imposition of a fine of $5,000 or more for violation of any provision of any securities law or regulation, or any agreement with or rule or standard of conduct of any securities governmental agency, securities self-regulatory organization, or as imposed by any such regulatory or self-regulatory organization in connection with a disciplinary proceeding; or

(C) is ordered as a sanction in a disciplinary action to retake the Regulatory Element by any securities governmental agency or self-regulatory organization.

The retaking of the Regulatory Element shall commence with participation within 120 days of the registered person becoming subject to the statutory disqualification, in the case of (A) above, or the disciplinary action becoming final, in the case of (B) and (C) above. The date of the disciplinary action shall be treated as such person's new base date with NASD.

(4) Reassociation in a Registered Capacity

Any registered person who has terminated association with a member and who has, within two years of the date of termination, become reassociated in a registered capacity with a member shall participate in the Regulatory Element at such intervals that may apply (second anniversary and every three years thereafter) based on the initial registration anniversary date rather than based on the date of reassociation in a registered capacity.

(5) Definition of Registered Person

For purposes of this Rule, the term "registered person" means any person registered with NASD as a representative, principal, assistant representative or research analyst pursuant to the Rule 1020, 1030, 1040, 1050 and 1110 Series.

(6) In-Firm Delivery of the Regulatory Element

Members will be permitted to administer the continuing education Regulatory Element program to their registered persons by instituting an in-firm program acceptable to the Association.

The following procedures are required:

(A) Principal/Officer In-Charge. The firm has designated a principal to be responsible for the in-firm delivery of the Regulatory Element.

(B) Site Requirements.

(i) The location of all delivery sites will be under the control of the firm.

(ii) Delivery of Regulatory Element continuing education will take place in an environment conducive to training. (Examples: a training facility, conference room or other area dedicated to this purpose would be appropriate. Inappropriate locations would include a personal office or any location that is not or cannot be secured from traffic and interruptions.)

(iii) Where multiple delivery terminals are placed in a room, adequate separation between terminals will be maintained.

(C) Technology Requirements. The communication links and firm delivery computer hardware must comply with standards defined by the Association or its designated vendor.

(D) Supervision.

(i) The firm's Written Supervisory Procedures must contain the procedures implemented to comply with the requirements of in-firm delivery of the Regulatory Element continuing education.

(ii) The firm's Written Supervisory Procedures must identify the principal designated pursuant to Rule 1120(a)(6)(A) and contain a list of individuals authorized by the firm to serve as proctors.

(iii) Firm locations for delivery of the Regulatory Element continuing education will be specifically listed in the firm's Written Supervisory Procedures.

(E) Proctors.

(i) All sessions will be proctored by an authorized person during the entire Regulatory Element session. Proctors must be present in the session room or must be able to view the person(s) sitting for Regulatory Element continuing education through a window or by video monitor.

(ii) The individual responsible for proctoring at each administration will sign a certification that required procedures have been followed, that no material from

Regulatory Element continuing education has been reproduced, and that no candidate received any assistance to complete the session. Such certification may be part of the sign-in log required under Rule 1120(a)(6)(F).

(iii) Individuals serving as proctors must be persons registered with an SRO and supervised by the designated principal for purposes of in-firm delivery of the Regulatory Element continuing education.

(iv) Proctors will check and verify the identification of all individuals taking Regulatory Element continuing education.

(F) Administration.

(i) All appointments will be scheduled in advance using the procedures and software specified by the Association to communicate with the Association's system and designated vendor.

(ii) The firm/proctor will conduct each session in accordance with the administrative appointment scheduling procedures established by the Association or its designated vendor.

(iii) A sign-in log will be maintained at the delivery facility. Logs will contain the date of each session, the name and social security number of the individual taking the session, that required identification was checked, the sign-in time, the sign-out time, and the name of the individual proctoring the session. Such logs are required to be retained pursuant to SEC Rules 17a-3 and 17a-4.

(iv) No material will be permitted to be utilized for the session nor may any session-related material be removed.

(v) Delivery sites will be made available for inspection by the SROs.

(vi) Before commencing in-firm delivery of the Regulatory Element continuing education, members are required to file with their Designated Examining Authority ("DEA"), a letter of attestation (as specified below) signed by a principal executive officer or executive representative, attesting to the establishment of required procedures addressing principal in-charge, supervision, site, technology, proctors, and administrative requirements. Letters filed with NASD Regulation, Inc. should be sent to Member Regulation, Continuing Education Department, 9509 Key West Avenue, Rockville, MD 20850.

Letter of Attestation for In-Firm Delivery of Regulatory Element Continuing Education

[Name of member] has established procedures for delivering Regulatory Element continuing education on its premises. I have determined that these procedures are reasonably designed to comply with SRO requirements pertaining to in-firm delivery of Regulatory Element continuing education, including that such procedures have been implemented to comply with principal/officer in-charge, supervision, site, technology, proctors, and administrative requirements.

Signature

____

Printed name

____

Title [Must be signed by a Principal Executive Officer (or Executive Representative) of the firm]

____

Date

(7) Regulatory Element Contact Person

Each member shall designate and identify to NASD (by name and e-mail address) an individual or individuals responsible for receiving e-mail notifications provided via the Central Registration Depository regarding when a registered person is approaching the end of his or her Regulatory Element time frame and when a registered person is deemed inactive due to failure to complete the requirements of the Regulatory Element program, and provide prompt notification to NASD regarding any change in such designation(s). Each member must review and, if necessary, update the information regarding its Regulatory Element contact person(s) within 17 business days after the end of each calendar quarter to ensure the information's accuracy.

(b) Firm Element

(1) Persons Subject to the Firm Element

The requirements of this subparagraph shall apply to any person registered with a member who has direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, any person registered as a research analyst pursuant to Rule 1050, and to the immediate supervisors of such persons (collectively, "covered registered persons"). "Customer" shall mean any natural person and any organization, other than another broker or dealer, executing securities transactions with or through or receiving investment banking services from a member.

(2) Standards for the Firm Element

(A) Each member must maintain a continuing and current education program for its covered registered persons to enhance their securities knowledge, skill, and professionalism. At a minimum, each member shall at least annually evaluate and prioritize its training needs and develop a written training plan. The plan must take into consideration the member's size, organizational structure, and scope of business activities, as well as regulatory developments and the performance of covered registered persons in the Regulatory Element. If a member's analysis establishes the need for supervisory training for persons with supervisory responsibilities, such training must be included in the member's training plan.

(B) Minimum Standards for Training Programs — Programs used to implement a member's training plan must be appropriate for the business of the member and, at a minimum must cover the following matters concerning securities products, services, and strategies offered by the member:

(i) General investment features and associated risk factors;

(ii) Suitability and sales practice considerations;

(iii) Applicable regulatory requirements; and

(iv) With respect to registered research analysts and their immediate supervisors, training in ethics, professional responsibility and the requirements of Rule 2711.

NASD members must implement the provisions of Rule 1120(b)(2)(B)(iv) on January 26, 2004, or such later date as determined by NASD

(C) Administration of Continuing Education Program — A member must administer its continuing education programs in accordance with its annual evaluation and written plan and must maintain records documenting the content of the programs and completion of the programs by covered registered persons.

(3) Participation in the Firm Element

Covered registered persons included in a member's plan must take all appropriate and reasonable steps to participate in continuing education programs as required by the member.

(4) Specific Training Requirements

The Association may require a member, individually or as part of a larger group, to provide specific training to its covered registered persons in such areas as the Association deems appropriate. Such a requirement may stipulate the class of covered registered persons for which it is applicable, the time period in which the requirement must be satisfied and, where appropriate, the actual training content.

Amended by SR-NASD-2004-098 eff. April 4, 2005.
Amended by SR-NASD-2003-183 eff. April 16, 2004.
Amended by SR-NASD-2002-154 eff. July 29, 2003.
Amended by SR-NASD-2000-64 eff. March 11, 2001.
Amended by SR-NASD-98-03 eff. July 1, 1998.
Amended by SR-NASD-95-22 eff. July 1, 1995.
Adopted by SR-NASD-94-72 eff. July 1, 1995.

Selected Notices to Members: 94-59, 95-13, 95-35, 96-27, 98-23, 01-14, 03-44, 04-22, 05-20.

Notice to Members

JULY 2002

SUGGESTED ROUTING

Executive Representative

Legal & Compliance

Operations

Senior Management

KEY TOPICS

Advertising

Investment Banking

Research Reports

Research Analysts and Research Reports

SEC Approves Rule Governing Research Analysts' Conflicts of Interest

Executive Summary

On May 10, 2002, the SEC approved new NASD Rule 2711, Research Analysts and Research Reports. The rule is intended to improve the objectivity of research and provide investors with more useful and reliable information when making investment decisions. The SEC also approved on that day similar proposed amendments to New York Stock Exchange (NYSE) Rule 472. The rules will be implemented in phases during the period from July 9, 2002, to November 6, 2002.

This *Notice* includes as Attachment A the text of the new rule and the implementation schedule of the rule's effective dates. This *Notice* also includes as Attachment B a Joint Memorandum of NASD and the NYSE that provides interpretive guidance for the NASD and NYSE rules governing research reports and analysts.

Research Reports Must Reflect an Analyst's Actual Opinion

Rule 2711 is intended to restore investor confidence in a process that is critical to the equities markets. The rule reflects a self-policing approach consistent with strong self-regulation. Members and research analysts must take all measures that are necessary to ensure that all research reports reflect an analyst's honest views and that any opinion or recommendation is not influenced by conflicts of interest. If a member issues a report or a research analyst renders an opinion that is inconsistent with the analyst's actual views regarding a subject company, NASD considers such action to constitute a fraudulent act and conduct inconsistent with just and equitable principles of trade.

Disclosure Required by NASD Rule 2210

The Joint Memorandum discusses interpretive issues that are common to NASD Rule 2711 and NYSE Rule 472 with regard to research reports and research analysts. Members should refer to the Joint Memorandum for a discussion of most of these interpretive issues.

One issue is unique to NASD members, however, and thus covered in this *Notice*. In addition to the disclosures required by Rule 2711, NASD members and research analysts must provide disclosure in research reports that is required by NASD Rule 2210. In two cases, Rule 2711's disclosure requirements operate differently than those under Rule 2210.

First, Rule 2210(d)(2)(B)(i)(a) requires disclosure if the member *"usually makes a market* in the securities being recommended," while Rule 2711(h)(8) requires disclosure if the member "was making a market in the subject company's securities *at the time that the research report was published."* Second, Rule 2210(d)(2)(B)(i)(c) requires disclosure if the member was manager or co-manager of a public offering of any securities of the recommended issuer within the last three years, while Rule 2711(h)(2)(A)(ii)(a) only requires disclosure of this information for the past *12 months*.

In these two situations, a member's compliance with the requirements of Rule 2711(h) will override the disclosure requirements of Rule 2210(d)(2)(B)(i). Members still must comply with all other disclosure requirements of Rule 2210, such as those regarding buying or selling securities on a principal basis and ownership of options, rights, or warrants. Additionally, member communications other than research reports remain subject to all applicable provisions of Rule 2210, including those regarding recommendations.

Questions/Further Information

Questions or comments concerning NASD Rule 2711 or this *Notice* may be directed to the NASD Corporate Financing Department at (240) 386-4623.

Information Memo

New York Stock Exchange, Inc.
20 Broad Street
New York, NY 10005

Member Firm Regulation

NYSE

Number 02-26
June 26, 2002

ATTENTION: CHIEF EXECUTIVE OFFICER, MANAGING PARTNERS, RESEARCH, COMPLIANCE, LEGAL, AND INVESTMENT BANKING DEPARTMENTS

TO: ALL MEMBERS AND MEMBER ORGANIZATIONS

SUBJECT: DISCLOSURE AND REPORTING REQUIREMENTS

On May 10, 2002, the Securities and Exchange Commission approved amendments to Exchange Rule 472 ("Communications with the Public") and Rule 351 ("Reporting Requirements")[1] (see attached Exhibit B). The SEC also simultaneously approved new NASD Rule 2711 ("Research Analysts and Research Reports").

The amendments place prohibitions and/or restrictions on Investment Banking Department, Research Department and Subject Company relationships and communications and impose new disclosure requirements on members and member organizations and their associated persons. The amendments are intended to increase associated persons' (research analysts) independence from influences within their firms and provide disclosure of conflicts of interests which might potentially bias such associated persons and the research reports they produce.

This Information Memo includes a Joint Memorandum of NYSE and NASD (see attached Exhibit A) that provides interpretive guidance for the new NYSE and NASD Rules as well as the implementation schedule for the Rules (please see NYSE Information Memo No. 02-24, dated May 20, 2002, for additional information).

Questions regarding this Memo may be directed to William Jannace at (212) 656-2744 or Mary Anne Furlong at (212) 656-4823.

Salvatore Pallante
Executive Vice President

Attachments

[1] SR-NYSE-2002-09, Securities Exchange Act Release No. 45908 (May 10, 2000).

NYSE
New York Stock Exchange

NASD

JOINT MEMORANDUM
OF
NASD AND THE NEW YORK STOCK EXCHANGE

Discussion and Interpretation of Rules Governing Research Analysts and Research Reports (NASD Rule 2711 and NYSE Rules 351 and 472)

Background

On May 10, 2002, the Securities and Exchange Commission ("SEC") approved new NASD Rule 2711 ("Research Analysts and Research Reports") and amendments to New York Stock Exchange ("NYSE") Rules 351 ("Reporting Requirements") and 472 ("Communications with the Public") with respect to research analysts and research reports (collectively, NASD Rule 2711 and the amendments to NYSE Rules 351 and 472 are referred to as the "SRO Rules").

The SRO Rules implement reforms designed to increase analyst independence and to provide more extensive disclosure of conflicts of interest in research reports and public appearances. Generally, the SRO Rules restrict the relationship between research and investment banking departments; require disclosure of financial interests in covered companies by the analyst and the firm; require disclosure of existing and potential investment banking relationships with subject companies; impose quiet periods for the issuance of research reports; restrict personal trading by analysts; and require disclosure of information that helps investors track the correlation between an analyst's rating and the stock's price movements.

The SRO Rules are being phased in to give members time to adopt compliant systems and procedures. Most provisions of the Rules will go into effect on July 9, 2002, with the following exceptions. The provisions requiring disclosure of firm ownership of 1% or more of any class of common equity securities of the subject company[1] and related written procedures[2] become effective November 6, 2002. The following rules and their accompanying written procedures become effective on September 9, 2002: the gatekeeper functions;[3] the required disclosure of ratings distribution;[4] and the price charts.[5] The NYSE had previously issued an information

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1 NASD Rule 2711(h)(1)(B) and NYSE Rule 472(k)(1)(i)a.

2 NASD Rule 2711(i) and NYSE Rule 472(c).

3 NASD Rule 2711(b)(2) and (3), NASD Rule 2711(c)(1) and (2) and NYSE Rule 472(b)(2) and (3).

4 NASD Rule 2711(h)(5) and NYSE Rule 472(k)(2)(iv).

5 NASD Rule 2711(h)(6) and NYSE Rule 472(k)(2)(v).

memo outlining the implementation schedule (see NYSE Information Memo No. 02-24, dated May 20, 2002).

In its approval order, the SEC noted that NASD and the NYSE (collectively, the "SROs") would provide interpretive guidance on certain provisions of the SRO Rules. This Joint Memorandum provides that guidance, and addresses certain other issues that NASD and NYSE members have raised since the SEC approved the SRO Rules. This Joint Memorandum does not attempt to address every possible interpretive question or factual scenario that might arise under the Rules. As with other SRO Rules, the NASD and NYSE staffs will consider additional requests for interpretive guidance on a case-by-case basis.

For purposes of the NYSE Rules, the term "research analyst" as used in the Joint Memorandum refers to any "associated person" as that term is defined in NYSE Rule 472.40. In addition, for purposes of the NYSE Rules, the term "member" refers to both members and member organizations of the NYSE.

Definitions

The SRO Rules include a number of definitions that are important to their application. Certain of these definitions are discussed in more detail below.

Investment Banking Services

The SRO Rules[6] define "investment banking services" to include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs (private investment, public equity transactions) or similar investments; or serving as placement agent for the issuer. The term also includes acting as a member of a selling group in a securities underwriting.

Household Members

NASD Rule 2711(a)(3) defines the term "member of a research analyst's household," and NYSE Rule 472.40 defines the term "household member," to mean any individual whose principal residence is the same as the research analyst's principal residence. These terms do *not* include, however, a roommate, apartment mate or other *unrelated* person who shares the same residence as a research analyst if that person is not financially dependent on the research analyst, or the research analyst is not financially dependent on that person.

Public Appearance

"Public appearance" is defined in the SRO Rules[7] to mean any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security. This term includes a research analyst's participation in a conference call or web cast that is open to the public in which the analyst makes a recommendation or offers an opinion concerning an equity security.

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[6] NASD Rule 2711(a)(2) and NYSE Rule 472.20

[7] NASD Rule 2711(a)(4) and NYSE Rule 472.50

Research Analyst and Associated Person

NASD Rule 2711(a)(5) defines "research analyst" to mean "the associated person who is principally responsible for, and any associated person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report, whether or not any such person has the job title of 'research analyst.'" NYSE Rule 472.40 defines "associated person" for purposes of its rule to include "a member, allied member, or employee of a member or member organization responsible for, and any person who reports directly or indirectly to such associated person in connection with the making of the recommendation to purchase, sell or hold an equity security in research reports, or public appearances or establish a rating or price target of a subject company's equity securities."

These terms do not include every registered person who may express an opinion on an equity security. Thus, for example, the terms exclude registered representatives who recommend securities to their customers, so long as they do not prepare the substance of research reports and do not report to persons who do prepare research reports. The terms also exclude investment advisers, such as mutual fund portfolio managers, who are not principally responsible for preparing the substance of a research report, even if they are registered persons of members.

Research Analyst Account

NASD Rule 2711(a)(6) defines "research analyst account" to mean any account in which a research analyst or member of the research analyst's household has a financial interest or over which the analyst has discretion or control. NYSE Rule 472 does not include a comparably defined term. However, NYSE Rule 472.40 generally applies the rule's personal trading restrictions and disclosure requirements to any account over which an associated person has a financial interest, or over which the associated person exercises discretion or control. Under both NASD Rule 2711(a)(6) and NYSE Rule 472.40, if a research analyst manages the portfolio investments of a registered investment company, the investment company is not a "research analyst account" for purposes of NASD Rule 2711, and is not subject to the personal trading restrictions or disclosure requirements of NYSE Rule 472.

Research Report

Under the SRO Rules,[8] the term "research report" has four components. A "research report" is (1) a written or electronic communication, (2) that includes an analysis of equity securities of individual companies or industries, (3) that provides information reasonably sufficient upon which to base an investment decision, and (4) that includes a recommendation. Members should consider each communication in this context in determining whether it is or is not a "research report." The term "research report" includes any public communication of a member that falls within the definition, regardless of the means of distribution or whether the report of the member is distributed within or outside the United States.

Member communications that mention or discuss particular equity securities come in a variety of forms, and it is not possible to provide a complete list of all types of communications that fall or do not fall within this definition. The issue of whether a particular communication constitutes a "research report" for purposes of the SRO Rules will turn on the individual facts and circumstances surrounding that communication. The SROs generally would *not* consider the following communications to be "research reports":

- Reports discussing broad-based indices, such as the Russell 2000 or S&P 500 index, that do not recommend or rate individual securities.
- Reports commenting on economic, political or market conditions that do not recommend or rate individual securities.
- Technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price.
- Statistical summaries of multiple companies' financial data (including listings of current ratings) that do not include any narrative discussion or analysis of individual companies' data.
- Reports that recommend increasing or decreasing holdings in particular industries or sectors but that do not contain recommendations or ratings for individual securities.
- Notices of ratings or price target changes that do not contain any narrative discussion or analysis of the company, provided that the member simultaneously directs the readers of the notice as to where they may obtain the most recent research report on the subject company that includes the disclosures required by the SRO Rules. In no event should such a notice refer to a research report that contains materially misleading disclosure, i.e., where disclosures are no longer applicable or new disclosures would pertain.
- An analysis prepared by a registered representative for a specific customer's account.
- Internal communications that are not given to customers.

For purposes of this definition, the term "equity security" has the same meaning as defined in Section 3(a)(11) of the Securities Exchange Act of 1934 (the "Exchange Act").[9]

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[8] NASD Rule 2711(a)(8) and NYSE Rule 472.10(2).

[9] *See* 15 U.S.C. 78c(a)(11).

Application of the SRO Rules to Third Party Research

The SROs have received a number of questions regarding whether the SRO Rules apply to research distributed by a member that is produced by a third party. In general, the SRO Rules are intended to address conflicts of interest that can arise when a member produces its own research. When a member distributes research produced by an independent third party generated in accordance with a soft-dollar arrangement, the member's disclosure requirements do not apply. If the independent third-party source of the research is also an NASD or NYSE member, the third-party member firm must comply with the applicable SRO Rules' provisions described below.

In some cases, a member may distribute research produced by a non-member affiliate, such as a foreign broker/dealer or an investment adviser, or an independent third party other than through a soft-dollar arrangement. The member must however, accompany this research with the following disclosures, to the extent applicable:

- the member's and its affiliates' ownership of the subject company's securities;[10]
- that the member or its affiliates managed or co-managed a public offering of the subject company's securities in the past 12 months, received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;[11]
- that the member was making a market in the subject company's securities at the time the research report was published;[12] and
- any other actual, material conflict of interest of the member known at the time of distribution of the research report.[13]

Generally, a member will not be considered to have distributed independent third-party research to a customer when the customer independently requests or accesses such research from the member or the member makes such research available to its customers through the member's or a third party's web site and customers select their own research.

Prohibition of Certain Forms of Analyst Compensation

The SRO Rules[14] expressly prohibit the payment of a "bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services

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[10] NASD Rule 2711(h)(1)(B) and NYSE Rule 472(k)(1)(i)a.

[11] Rules NASD Rule 2711(h)(2)(A)(ii) and NYSE Rule 472(k)(1)(ii).

[12] NASD Rule 2711(h)(8) and NYSE Rule 472(k)(2)(i).

[13] NASD Rule 2711(h)(1)(C) and NYSE Rule 472(k)(1)(i)c. as they pertain solely to the member.

[14] NASD Rule 2711(d) and NYSE Rule 472(h).

transaction." The SROs have received questions as to the continuing validity of existing contractual arrangements that contain compensation agreements contrary to these SRO Rule provisions.

The SROs are of the view that as of the effective date for that provision of the SRO Rules (July 9, 2002), any contractual provision that provides for compensation based upon specific banking transactions that have not yet closed is inconsistent with the SRO Rules. A member may not pay compensation based on specific investment banking transactions that may have been entered into before the effective date but that will not close until after the effective date. However, research analysts may be compensated, pursuant to contractual agreements executed prior to July 9, 2002, for any investment banking transactions that have closed before that date.

Prohibition of Promises of Favorable Research

The SRO Rules[15] prohibit members from directly or indirectly offering a company favorable research, a specific rating or a specific price target, or threatening to change research, a rating or price target, as consideration or inducement for the receipt of business or compensation. These provisions extend to the research, ratings and price targets issued by an affiliate, since the rule prohibits indirect as well as direct actions.

Nevertheless, these provisions are not intended to prevent a member's investment banking department from obtaining a research analyst's view of a prospective client before committing to undertake an investment banking transaction. They also do not prevent a member from agreeing to provide research as part of its investment banking agreement with a subject company, so long as there is no promise of *favorable* research.

Quiet Periods

The SRO Rules[16] generally prohibit a member from publishing a research report on a company for which the member has acted as manager or co-manager for 40 calendar days after an initial public offering and 10 calendar days after a secondary offering. The SRO Rules provide an exception for publication of research concerning the effects of significant news or a significant event relating to the subject company during those quiet periods. For purposes of these Rules "significant news or a significant event" refers to any news or event that is expected to have a material impact on, or that is expected to cause a material change to, the subject company's operations, earnings or financial condition. The SRO Rules also exempt research reports issued pursuant to SEC Rule 139 for certain secondary offerings of "actively-traded" securities as defined in Rule 101(c)(1) of Regulation M of the Exchange Act.

The SRO Rules impose the 40-day or 10-day quiet periods, as applicable, following the date of the offering. Members have requested clarification of the definition of date of the offering. For NASD Rule 2711(f)(1) and NYSE Rule 472(f)(1) (regarding IPOs), members should use the effective date of the registration statement as the date of the offering. For some secondary offerings, particularly shelf-offerings, the effective date of registration may not be meaningful for the purposes of the Rules. Accordingly, for NASD Rule 2711(f)(2) and NYSE Rule 472(f)(2), the date of offering is the date on which the secondary shares are first offered to the public.

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15 NASD Rule 2711(e) and NYSE Rule 472(g).

16 NASD Rule 2711(f) and NYSE Rule 472(f)(1) and (2).

As noted above, the SRO Rules apply only to "equity security" offerings, as that term is defined in Section 3(a)(11) of the Exchange Act. This definition includes convertible debt offerings. The provisions do not apply with respect to straight debt offerings.

The quiet period requirements only apply to IPOs and secondary offerings that occur on or after July 9, 2002. Offerings that occur before July 9, 2002 are not subject to these provisions.

Personal Trading

The SRO Rules[17] impose a number of restrictions on the personal trading of securities in accounts in which a research analyst or a member of his or her household has a financial interest or over which the analyst has discretion or control. For purposes of both SROs' rules, these accounts are referred to herein as "research analyst accounts."

Prohibition of Purchasing or Receiving Pre-IPO Securities

The SRO Rules[18] prohibit a research analyst account from purchasing or receiving any securities before the issuer's initial public offering if the issuer is principally engaged in the same types of business as companies that the research analyst follows. This prohibition applies to shares of any private company that engages in the same types of business that the analyst follows, regardless of whether the company ever goes public.

The SRO Rules do not require a research analyst to divest pre-IPO shares of a company that the research analyst already owned before the SRO Rules' effective date. However, research analysts in these situations may not provide research on the company unless the analyst has divested all pre-IPO shares in the company.

The SROs have received questions on the meaning of the term "same types of business as companies that the research analyst covers." As a general matter, a member should assume that an issuer falls within this category if the issuer would be assigned to the analyst if the member began covering the issuer. To the extent that there are still questions, an acceptable approach would be to include all companies that are classified as being in the same industry as the companies that the analyst covers by a nationally recognized system of industry classification.

Blackout Periods

The SRO Rules[19] generally prohibit a research analyst account from purchasing or selling any security issued by a company that the research analyst follows, or any option on or derivative of such security, for a period beginning 30 calendar days before and ending 5 calendar days after the publication of a research report concerning the company or a change in a rating or price target of the company's securities. For purposes of this provision, the publication date of a research report is the date that a member first disseminates the report.

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17 NASD Rule 2711(g) and NYSE Rule 472(e).

18 NASD Rule 2711(g)(1) and NYSE Rule 472(e)(1).

19 NASD Rule 2711(g)(2) and NYSE Rule 472(e)(2).

Under the SRO Rules[20], a member may permit a research analyst to issue a research report or change a rating or price target for a subject company fewer than 30 days after a research analyst account has traded the subject company's securities if the report or change is due to significant news or a significant event concerning the subject company. The member's legal or compliance department must pre-approve the research report or any change in the subject company's rating or price target.

Exceptions for Investment Funds

The SRO Rules[21] exclude investments in certain investment funds from the personal trading restrictions in NASD Rule 2711(g)(1) through (g)(3) and NYSE Rule 472(e)(1) through (e)(3). The SRO Rules[22] provide that the personal trading restrictions do not apply to investments in registered diversified investment companies as defined in Section 5(b)(1) of the Investment Company Act of 1940.[23] If a research analyst invests in a registered investment company that is not diversified, the investment company must meet the requirements of NASD Rule 2711(g)(5)(B) and NYSE Rule 472(e)(4)(v) in order to be excluded from the personal trading restrictions.

The SRO Rules[24] also exclude any other investment fund over which neither the research analyst nor household member has any investment discretion or control from the personal trading restrictions, provided that the fund meets three criteria. First, the research analyst account(s) collectively owns interests representing no more than 1% of the assets of the fund. Second, the fund invests no more than 20% of its assets in the same types of business as companies that the research analyst follows.[25] Third, if the investment fund distributes securities in kind to the research analyst or household member before the issuer's IPO, the research analyst or household member must either divest those securities immediately or the research analyst must refrain from participating in the preparation of research reports concerning that issuer.

Members have inquired whether holdings of investment funds that were purchased or received prior to July 9, 2002 are excluded from the trading restrictions in the SRO Rules.[26] In general, the SROs will not apply the trading restrictions to these investments. However, if a research analyst or household member makes or receives additional investments in those funds after July 9, 2002, all fund holdings would be subject to the trading restrictions to the extent those funds do not meet the requirements of the SRO Rules.[27]

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[20] NASD Rule 2711(g)(2)(B) and NYSE Rule 472(e)(4)(ii).

[21] NASD Rule 2711(g)(5) and NYSE Rules 472(e)(4)(v) and (vi).

[22] NASD Rule 2711(g)(5)(A) and NYSE Rule 472(e)(4)(vi).

[23] 15 U.S.C. 80a-5(b)(1).

[24] NASD Rule 2711(g)(5)(B) and NYSE Rule 472(e)(4)(v).

[25] The phrase "same types of business as companies that the research analyst follows" has the same meaning as under the restrictions on purchasing and receiving pre-IPO securities. *See* discussion of NASD Rule 2711(g)(1) and NYSE Rule 472(e)(1).

[26] NASD Rule 2711(g)(1), (2) and (3) and NYSE Rule 472(e)(1), (2) and (3).

[27] NASD Rule 2711(g)(5)(B) and NYSE Rule 472(e)(4)(v).

Members also have inquired as to when the 1% and 20% tests must be measured. In order to qualify for the trading exceptions of the SRO Rules[28] an investment fund must meet the 1% and 20% tests each time a research analyst makes or receives additional investments in the fund.

Disclosure Requirements

The SRO Rules impose a number of disclosure requirements on members and research analysts with respect both to research reports and public appearances. Members are reminded that there may be additional disclosures required by SEC Rule 10b-5 or other securities laws and rules. Certain of the SRO Rules' disclosure requirements are discussed below.

Member Ownership of Subject Company Securities

The SRO Rules[29] require a member or research analyst to disclose in a research report and a public appearance if, as of the end of the month preceding publication of a research report or a public appearance, the "member or its affiliates" beneficially owned 1% or more of any class of common equity securities of the subject company. Several members have requested guidance as to the scope of "affiliate" ownership in this provision, including whether it encompasses mutual funds managed by an affiliated investment adviser, ownership by member employees, and trust accounts managed by an affiliated bank. Members have further inquired whether they may, or must, aggregate their affiliate positions for the purposes of the disclosure requirement.

The SRO Rules refer to Section 13(d) of the Exchange Act for the standards to determine what constitutes beneficial ownership. Thus, members must include the holdings of an affiliate or accounts managed by an affiliate to the same extent those holdings are subject to the Section 13(d) reporting requirements. Members should look to the SEC rules promulgated pursuant to Section 13(d) and relevant interpretations by the SEC to determine which affiliate holdings must be included in calculating whether firm ownership meets the 1% disclosure threshold. While firms must aggregate those affiliate positions that fall under the Section 13(d) reporting requirements, firms may additionally show those positions disaggregated from the member's own holdings.

The SRO Rules[30] further require disclosure of "any other actual, material conflict of interest" of which the analyst "knows or has reason to know" at the time of the research report or public appearance. Some members have asked whether this requirement creates a duty of inquiry by the analyst to learn of confidential, non-public information. The "knows or has reason to know" language is intended to require disclosure of those material conflicts of interest of which the analyst has actual knowledge, as well as those conflicts that should be reasonably discovered in the ordinary course of business. The provision does not impose a duty on an analyst to inquire concerning confidential, non-public material information that is properly segregated by a firm's informational barriers.

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[28] NASD Rule 2711(g)(5)(B) and NYSE Rule 472(e)(4)(v).

[29] NASD Rule 2711(h)(1)(B) and NYSE Rule 472(k)(1)(i)a.

[30] NASD Rule 2711(h)(1)(C) and NYSE Rule 472(k)(1)(i)c.

Member Receipt of Compensation from Subject Company

The SRO Rules[31] require a member to disclose in research reports if the member or its affiliates: (a) managed or co-managed a public offering of the subject company's securities in the past 12 months; (b) received compensation for investment banking services from the subject company in the past 12 months; or (c) expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months. The Rules do not define the term "affiliate" for purposes of this provision.

The SROs deem that the term "affiliate" includes any company that controls, is controlled by, or is under common control with, the member. "Affiliate" does not include individuals employed by the member or an affiliate. "Control" means the power to direct, or cause the direction of, the management or policies of a company, whether through ownership of securities, by contract or otherwise.[32]

Meaning of Ratings

The SRO Rules[33] require a member to define in its research reports the meaning of each rating used by the member in its ratings system. For example, a member might disclose that a "strong buy" rating means that the rated security's price is expected to appreciate at least 10% faster than other securities in its sector over the next 12-month period.[34] The definition of each rating must be consistent with its plain meaning. Thus, for example, a "hold" rating should not mean or imply that an investor should sell a security.

In some cases, a member may employ multiple ratings systems based upon the investor's time horizon. For example, the member may present ratings for "long," "intermediate" and "short" term investors. In such cases, the member is required to disclose the meanings of the ratings used in each of the ratings systems.

Distribution of Ratings

The SRO Rules[35] require a member to disclose in each research report the percentage of all securities rated by the member to which the member has assigned a "buy," "hold/neutral" or "sell" rating. For example, a research report might disclose that the member has assigned a "buy" rating to 58% of the securities that it follows, a "hold/neutral" rating to 15%, and a "sell" rating to 27%. The SRO Rules[36] require this information to be current as of the end of the most recent calendar quarter . If the publication date of the research report is fewer than 15 calendar days after the end of the most recent calendar quarter, the information must be current as of the second most recent calendar quarter end. If a firm does not employ a rating system that uses the terms

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[31] NASD Rule 2711(h)(2)(A)(ii) and NYSE Rule 472(k)(1)(ii).

[32] *See also* NASD Rule 2720(b)(1) and NYSE Rule 2.

[33] NASD Rule 2711(h)(4) and NYSE Rule 472(k)(2)(iii).

[34] When a rating is defined in terms of a security's performance relative to the market or sector, there is no requirement also to disclose a member's market or sector forecast.

[35] NASD Rule 2711(h)(5)(A) and NYSE Rule 472(k)(2)(iv).

[36] NASD Rule 2711(h)(5)(C) and NYSE Rule 472.70.

"buy," "hold/neutral" and "sell," a member must determine, based on its own ratings system, into which of the three categories its ratings fall.

When a member employs multiple ratings systems based on the investor's time horizon, the member is required to disclose the distributions of the ratings used in each of the ratings systems. As discussed above, the distribution need only reflect ratings of equity securities as defined by Section 3(a)(11) of the Exchange Act.

The SRO Rules[37] require a member to disclose in each research report the percentage of subject companies within each of the three categories (buy, hold/neutral, sell) for whom the member has provided investment banking services within the last 12 months. For example, if 20 of the 25 companies to which the member has assigned a "buy" rating are investment banking clients of the member, the member would have to disclose that 80% of the companies that received a "buy" rating are its investment banking clients.

Price Chart

The SRO Rules[38] require members to include with any research report in which the member has assigned a rating for at least one year a graph that indicates the correlation between the price movement of the subject security and the ratings and price targets assigned by the member. The line graph must cover the period for which a member has assigned a rating or three years, whichever is shorter. This requirement has raised several questions.

First, members have inquired whether a table may be substituted for the chart when the research report is delivered through a technology that will not allow transmission of graphic illustrations. A member may use a table in such circumstances, provided that the table provides all the required data and is presented in an easily readable format. If a table is used rather than a chart, the table is only required to provide the stock closing prices for the days on which the member assigned or changed a rating or price target. However, members may not opt to use a table format if technology is reasonably available to transmit the information as a chart.

Second, members have asked for guidance to comply with the price chart provision when the member employs multiple ratings systems depending on the investor's time horizon (e.g., short, intermediate and long-term). In such cases, the price chart must show the ratings and price targets assigned to the subject company's stock for each ratings system.

Third, members have asked whether the SRO Rules permit inclusion of a benchmark performance, such as the S&P 500 Index, in the price chart. Members may include such benchmarks at their discretion, so long as the information required by the rule is prominent and clearly depicted on the chart. If a member uses a benchmark in a research report's price chart, the member should use the same benchmark in the price charts for all research reports of subject companies within the same industry or peer group.

Fourth, members have inquired whether they must include information about ratings and price targets assigned before the SRO Rules become effective. Members must include that information on price charts for any security that has been assigned a rating for at least a year before a research report is issued. Members have also asked whether the SROs might exempt firms that do not

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[37] NASD Rule 2711(h)(5)(B) and NYSE Rules 472(k)(2)(iv) and 472.70.

[38] NASD Rule 2711(h)(6) and NYSE Rule 472(k)(2)(v).

have the historical information readily available in electronic databases that go back as many as three years from the effective date. The price chart provision does not take effect until September 9, 2002. This date provides adequate time to compile the necessary information, particularly given the fact that existing NASD Rule 2210(b)(2) and NYSE Rule 472(d) (formerly Rule 472(c)) already require firms to maintain a file of all sales literature, including research reports, for three years.

Fifth, members have sought guidance on their obligations when coverage of a security is transferred from one analyst to another, i.e., whether the chart should reflect only the recommendations and price targets of the analyst to whom the security is currently assigned, or whether it should reflect data from all analysts during the period covered by the chart. The price chart is intended to depict the recommendations of the member, not the individual analyst. Consequently, the price chart must reflect all ratings and price targets during the specified period, irrespective of the analyst. The SROs would not object, however, if members chose to include additional information on the price chart that indicates when coverage shifted to a new analyst.

Sixth, some members have asked how "breaks" in coverage affect the obligation to include historical data for securities that have been assigned a rating for at least one year. Breaks in coverage would not restart the clock to determine the one-year coverage period. Moreover, the SROs expect members to indicate the breaks in coverage on the price charts.

Price Targets

The SRO Rules[39] require a member to disclose in research reports the valuation methods used to determine a price target. Price targets must have a reasonable basis and must be accompanied by disclosure concerning the risks that may impede achievement of a price target. This provision however does not require a member to include a price target in a research report.

Prominence of Disclosure

The disclosures required by the SRO Rules must appear on the front page of the research report or the front page must refer to the page on which disclosures are found. Disclosures and references to disclosures must be clear, comprehensive and prominent.

Electronic research reports may utilize hyperlinks to this disclosure, provided that the first screen that the investor sees clearly and prominently labels the hyperlinks to the required disclosures. When hyperlinks are not possible (such as a report in PDF format), members should follow the requirements for paper reports. Thus, for example, the first printed page of a PDF document must either have the disclosures or refer the reader to the pages where the disclosures appear.

Compendium Reports

If a member distributes a research report covering six or more subject companies, the member is not obligated to include the disclosures required by the SRO Rules, provided that the report directs readers in a clear manner as to where they may obtain applicable current disclosures for all covered companies in written or electronic format. In this regard, a compendium report must provide a toll-free number to call or a postal address to write for the required disclosures. Electronic compendium research reports may instead include a hyperlink to the required

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[39] NASD Rule 2711(h)(7) and NYSE Rule 472(k)(2)(ii).

disclosures. Paper research reports may also include a web address of the member where the disclosures are located.

While members are not obligated to include these disclosures in a compendium report so long as the report directs readers to where they may obtain the applicable current disclosures, members are encouraged to disclose in the compendium report the distribution of the member's ratings as required by NASD Rule 2711(h)(5) and NYSE Rule 472(k)(2)(iv). Because this disclosure is not unique to a particular subject company, this disclosure will be the same regardless of the number of subject companies covered in a compendium report.

Public Appearances

The SRO Rules require an analyst to disclose the following when making a recommendation during a public appearance: any financial interest held by the analyst or his or her household members; whether the firm and its affiliates, as of the end of the preceding month, held at least a 1% ownership interest in any class of common equity shares of the subject company; any other material conflict of interest of the analyst or firm of which the analyst knows or has reason to know; and whether the subject company is a client of the member or its affiliates. The term "public appearance" is defined and discussed above.

The SROs have received a number of questions regarding these provisions. First, some members asked whether the rule applies to analysts who make public appearances outside of the United States. The SRO Rules apply to any public appearance by a person who meets the definition of research analyst. They do not apply to employees of non-members unless they also are employees of the member.

Second, the SRO Rules[40] require a research analyst to disclose in public appearances if the analyst knows or has reason to know that the subject company is an investment banking client of the firm. As used herein, the term "client" is intended to include those clients from whom the member received revenues from investment banking services within the last 12 months, or for whom the member expects to provide investment banking services in the next three months, as disclosed in the most recent research report.

Third, several members have inquired whether the public appearance disclosures must be made during an extemporaneous radio or television interview when the research analyst does not possess the required disclosure information. If an analyst cannot make all of the required disclosures during a public appearance then the analyst must decline to make a recommendation or offer an opinion.

A related question is whether a research analyst has complied with the Rules if he or she makes all of the required disclosures during an interview, but the media outlet edits out the disclosures when all or part of the appearance is broadcast. The SROs cannot control the editorial decisions of the media. An analyst will not violate the Rules if he or she makes all of the mandated disclosures with a good faith belief, based on discussions with the media outlet, that those disclosures will be included whenever the appearance is broadcast or rebroadcast. However,

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40 *See* NASD Rule 2711(h)(2)(B) (which requires disclosure if the research analyst knows or has reason to know that the subject company is a "client" of the member or its affiliates) and NYSE Rule 472(k)(1)(ii) (which requires disclosure if the associated person knows or has reason to know that the subject company is an "investment banking services client" of the member, member organization or one of its affiliates).

when an analyst or a member is aware that a particular media outlet has previously edited out the required disclosures, the SROs expect that an analyst will decline subsequent appearances, absent assurances that the disclosures will not be edited out.

Fourth, members have asked whether the required disclosures may appear in a graphics box or a "scroll" across the screen in lieu of oral disclosures during a television or other video appearance. Such disclosure would satisfy the Rules, provided the graphic includes all of the required information presented in a prominent and readable format during the time of the appearance.

Finally, members have asked for guidance about the types of records that they should maintain to demonstrate compliance with the public appearance provisions of the Rules. Members must maintain records of appearances on television, radio or the Internet that are sufficient to record the statements made by a research analyst. These records may include a transcript or an audio or video tape of such an appearance.

Notice to Members

MARCH 2004

SUGGESTED ROUTING

Executive Representative
Investment Banking
Legal & Compliance
Operations
Research
Senior Management

KEY TOPICS

Advertising
Investment Banking
Research Reports

GUIDANCE

Research Analysts and Research Reports

NASD and NYSE Provide Further Guidance on Rules Governing Research Analysts' Conflicts of Interest

Executive Summary

In July 2002, NASD and the New York Stock Exchange (together, the SROs) issued a joint memorandum (the July 2002 Joint Memo) that provides interpretive guidance on NASD Rule 2711 (Research Analysts and Research Reports) and the research analyst provisions of NYSE Rules 351 and 472.[1] Since that time, the SROs have amended their rules governing research analysts and research reports,[2] and members have raised additional questions regarding these rules.

Accordingly, the SROs are issuing a second joint memorandum that provides further interpretive guidance to the research conflict of interest rules. Attachment A is the new joint memorandum. Attachment B is the current version of Rule 2711 for reference. Unless otherwise noted in the new joint memorandum, the guidance included in the July 2002 Joint Memo continues to apply.

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Joseph P. Savage, Counsel, Investment Companies Regulation, Regulatory Policy and Oversight (RPO), at (240) 386-4623; or Philip Shaikun, Associate General Counsel, RPO, at (202) 728-8451.

Endnotes

1 *See Notice to Members 02-39* (July 2002).

2 *See Notice to Members 03-44* (July 2003).

04-18

Information Memo

Member Firm Regulation

New York Stock Exchange, Inc.
20 Broad Street
New York, NY 10005

NYSE

Number 04-10
March 9, 2004

ATTENTION: CHIEF EXECUTIVE OFFICER, MANAGING PARTNERS, RESEARCH, COMPLIANCE, LEGAL, AND INVESTMENT BANKING DEPARTMENTS

TO: ALL MEMBERS AND MEMBER ORGANIZATIONS

SUBJECT: AMENDMENTS TO DISCLOSURE AND REPORTING REQUIREMENTS

On July 29, 2003, the Securities and Exchange Commission ("SEC") approved further amendments to Exchange Rule 472 ("Communications with the Public"), and amendments to Rule 351 ("Reporting Requirements"), Rule 344 ("Supervisory Analysts"), and Rule 345A ("Continuing Education for Registered Persons").[1] The SEC also simultaneously approved comparable amendments to NASD Rule 2711 ("Research Analysts and Research Reports"), Rule 1120 ("Continuing Education Requirements") and new Rule 1050 ("Registration of Research Analysts") (collectively NYSE and NASD Rules are referred to as the "SRO Rules").

NYSE and NASD have prepared a Joint Memorandum (see attached Exhibit A) that provides clarification and interpretive guidance to the SRO Rules (see attached Exhibit B for NYSE Rules).

Questions regarding this Memo may be directed to William Jannace at 212-656-2744 or Donald van Weezel at (212) 656-5058.

Salvatore Pallante
Executive Vice President

Attachments

[1] See Securities Exchange Act Release No. 48252 (July 29, 2003), 68 FR 45875 (August 4, 2003) (SR-NYSE-2002-49).

NYSE
New York Stock Exchange

NASD

JOINT MEMORANDUM
OF
NASD AND THE NEW YORK STOCK EXCHANGE

Discussion and Interpretation of Rules Governing Research Analysts and Research Reports (NASD Rule 2711 and NYSE Rules 351 and 472)

Background

This is a follow up to the joint memorandum issued by NASD and the New York Stock Exchange (the "SROs")[1] in July of 2002 (the "July 2002 Joint Memo") that provided interpretive guidance on NASD Rule 2711 ("Research Analysts and Research Reports") and amendments to NYSE Rule 472 ("Communications with the Public") and Rule 351 ("Reporting Requirements") (collectively, the "SRO Rules").[2]

In July 2003, the Securities and Exchange Commission ("SEC") approved further changes to the SRO Rules that imposed new requirements on members[3] and made other changes necessary to comply with research analyst provisions of the Sarbanes-Oxley Act of 2002 (the "July 2003 Amendments").[4] This joint memorandum serves two purposes. First, the memorandum provides further clarification of previously issued interpretive guidance in light of the July 2003 Amendments. Second, it provides further interpretive guidance on the SRO Rules and responds to common questions that members have asked since the July 2002 Joint Memo was issued.

Continued Applicability of July 2002 Joint Memo

Members have inquired whether the guidance provided in the July 2002 Joint Memo continues to apply given the July 2003 Amendments. Unless otherwise noted below in this memorandum, the guidance in the July 2002 Joint Memo continues to reflect the SROs' interpretations of the SRO Rules. This memorandum is organized by subject matter and any change to the previous guidance in the July 2002 Joint Memo is noted in the applicable section.

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1 *See* NASD Notice to Members 02-39 (July 2002) and NYSE Information Memo No. 02-26 (June 26, 2002), both of which included a Joint Memorandum.

2 *See* SEC Release No. 34-45908 (May 10, 2000), 67 Fed. Reg. 34968 (May 16, 2002).

3 For purposes of the NYSE Rules, the term "member" as used in this Joint Memorandum refers to both members and member organizations of the NYSE.

4 *See* SEC Release No. 34-48252 (July 29, 2003), 68 Fed. Reg. 45875 (Aug. 4, 2003).

Applicability of Registration and Continuing Education Requirements to Fixed Income Research Analysts

Members have inquired whether the new registration and continuing education requirements for research analysts[5] apply to research analysts that only produce research on fixed income securities. As a general matter, the research analyst registration requirements and continuing education requirements apply only to analysts that are the subject to the SRO Rules. That is, these requirements apply only to associated persons that are primarily responsible for the preparation of the substance of a research report on equity securities or whose name appears on such a research report. The requirements do not apply to research analysts that only produce research reports on fixed income securities that are not "equity securities" as defined in Section 3(a)(11) of the Securities Exchange Act of 1934.

Definition of "Research Report"

As of September 29, 2003, the term "research report" is defined as "a written or electronic communication that includes an analysis of equity securities or individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision."[6] Previously, the definition also required that the communication include a recommendation. That requirement was deleted in order to conform the SRO Rules to the definition of "research report" in the Sarbanes-Oxley Act.

While the SRO Rules no longer require that a research report contain a recommendation as a determining criteria, the analysis described in the July 2002 Joint Memo generally still applies. Although the issue of whether a communication is a research report still is determined by the individual facts and circumstances surrounding a particular communication, the list of exceptions in the July 2002 Joint Memo that are not generally "research reports" still applies under the new definition. Members should be aware that a disclaimer inserted into a communication with the public that indicates that the communication does not contain information sufficient upon which to base an investment decision has no relevance as to whether the communication falls within the definition of research report and could be misleading in certain circumstances.

Members have inquired whether a client communication that analyzes or recommends individual stocks would be considered a "research report" if it is written by an employee, such as a registered representative, who does not hold the title of "research analyst" and does not work in the member's research department. To clarify this issue, the SROs are adopting the interpretation issued by the SEC with respect to Regulation AC: a client communication that analyzes individual securities or companies will be considered a research report if it provides information reasonably sufficient upon which to base an investment decision and is distributed to

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5 NASD Rules 1050 and 1120 and NYSE Rules 344 and 345A

6 NASD Rule 2711(a)(8) and NYSE Rule 472.10(2).

at least 15 persons. This conclusion applies even if the author of the communication does not hold the title of "research analyst" and does not work in the member's research department.

The SROs also are adopting the SEC interpretation regarding periodic reports and other communications prepared for investment company shareholders or discretionary investment account clients.[7] Communications that discuss individual securities in the context of a fund's or account's past performance or the basis for previously made discretionary investment decisions (such as a manager's discussion of fund performance in a mutual fund shareholder report) are generally excluded from the definition of "research report."

Likewise, an investment company portfolio manager that prepares these types of communications would not be considered a "research analyst" for purposes of the SRO Rules even if he or she were registered with a member. However, if such a portfolio manager prepares communications that meet the definition of "research report" and do not fall within the exception noted above, those communications will be subject to the SRO Rules and the portfolio manager will be regarded as a research analyst.

Quantitative and Technical Research Reports

The SROs have continued to receive inquiries as to whether quantitative or technical research reports fall within the definition of "research report" under the SRO Rules. The July 2002 Joint Memo excluded from the definition of "research report" communications of "technical analysis concerning the demand and supply for a sector, index or industry based on trading volume and price." The SROs do not believe it is consistent with the purposes of the SRO Rules to exclude technical analysis of individual securities. Such an interpretation could allow a research analyst to provide coverage of a security of an issuer with which the member has an investment banking relationship or where the analyst may have a personal financial interest without the disclosures that would identify such potential conflicts. These are some of the very conflicts the SRO Rules are intended to address. The SEC similarly excluded from the definition of "research report" in Regulation AC only sector, index and industry technical analysis.

The SROs believe the term "quantitative" as applied to research can be subject to various interpretations. Indeed, many research reports typically labeled "quantitative" by members can and do raise conflicts concerns. In this regard, not all mathematical models are inherently objective. Many such models are based on subjective formulas where a person or persons selects or can change the inputs: for example, particular performance ratios or consensus earnings estimates. The SROs are concerned that such models based on subjective formulas could be manipulated to produce a desired result, depending on the ratios or other criteria selected, the universe of securities, and the formula employed.

Consequently, the SROs do not believe it appropriate to categorically exclude any "quantitative" research from the scope of the SRO Rules. Nonetheless, the SROs do recognize that certain "quantitative models" devised by members may sufficiently guard

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[7] *See* SEC Release Nos. 33-8193, 34-47384 (Feb. 20, 2003), 68 Fed. Reg. 9481, 9485 (Feb. 27, 2003).

against any potential conflicts of interest to render them outside the definition of a "research report." Thus, reports generated by formulas that are generally free of subjective inputs from an employee of a member may fall outside the definition of research report. However, the SROs believe that such a determination is best considered on a case-by-case basis.

Definition of "Public Appearance"

The SRO Rules define the term "public appearance" as "any participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security."[8] Members have inquired whether password-protected conference calls or web casts in which a research analyst provides his or her opinion on individual companies or securities constitute public appearances for purposes of the SRO Rules.

As discussed above, and consistent with SEC Regulation AC, an analysis of individual securities or companies prepared for a specific person or a limited group of fewer than 15 persons is not considered to be a "research report."[9] The SROs believe that a similar standard is appropriate to apply to public appearances. Thus, an appearance before persons representing 15 or more separate investors will be regarded as a public appearance for purposes of the SRO Rules. However, the SROs would not require an analyst to make the disclosures required for public appearances in a password protected web-cast, conference call or similar event with more than 15 existing customers (e.g. individuals or entities), provided (1) all of the call participants previously received the most current research report or other documentation that included the required disclosures and (2) the research analyst making the public appearance corrects and updates any disclosures in the research report that are inaccurate, misleading or are no longer applicable. If representatives of the media attend the public appearance, the analyst must make the required disclosures. Members also are reminded that such appearances are subject to appropriate record keeping requirements, which in this case must include a record of all attendees at the public appearance.

Application of SRO Rules to Third-Party Research

The July 2002 Joint Memo included guidance on the applicability of the SRO Rules to third-party research distributed by a member. That memo states that if a member distributes research produced by a non-member affiliate, such as a foreign broker/dealer or an investment adviser, or an independent third party (other than through a soft dollar arrangement), it must accompany this research with the following "Third-Party Research Disclosures," if applicable:

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[8] NASD Rule 2711(a)(4) and NYSE Rule 472.50.

[9] *See* SEC Release Nos. 33-8193, 34-47384 (Feb. 20, 2003), 68 Fed. Reg. 9481, 9485 (Feb. 27, 2003).

- the member's and its affiliates' ownership of the subject company's securities;[10]

- that the member or its affiliates managed or co-managed a public offering of the subject company's securities in the past 12 months, received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;[11]

- that the member was making a market in the subject company's securities at the time the research report was published;[12] and

- any other actual, material conflict of interest of the member known at the time of distribution of the research report.[13]

Absent a soft dollar arrangement, when a member distributes another member's research report, the distributing member must include the Third-Party Research Disclosures, while the member that prepared the report must comply with all of the disclosures required by the SRO Rules.

This memorandum addresses three questions that have arisen with respect to third-party research. (1) Are any of the new disclosures required by the recently amended SRO Rules now included in the required Third-Party Research Disclosures? (2) What factors determine whether a research report is considered to be the product of the member rather than its affiliate or an independent third party? (3) Do different rules apply to the distribution of non-member affiliate research and independent third-party research?

Disclosure of Non-Investment Banking Compensation

The July 2003 Amendments to the SRO Rules require a member to provide additional disclosure in research reports regarding compensation that it or its affiliates receive from the subject company. The SRO Rules now require a member to disclose if it received compensation for products or services other than investment banking. This information must be current as of the end of the month preceding the date of publication of the research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month). A member also must disclose if the analyst or an employee with ability to influence the substance of the research report has actual knowledge as of the date of publication that the member received such compensation.

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[10] NASD Rule 2711(h)(1)(B) and NYSE Rule 472(k)(1)(i)c.

[11] NASD Rule 2711(h)(2)(A)(ii) and NYSE Rule 472(k)(1)(i)a.

[12] NASD Rule 2711(h)(8) and NYSE Rule 472(k)(1)(i)b.

[13] NASD Rule 2711(h)(1)(C) and NYSE Rule 472(k)(1)(iii)d.

In addition, the July 2003 Amendments also generally require the disclosure in research reports of receipt of non-investment banking compensation received by a member's *affiliates*. However, a member is not required to disclose the receipt of non-investment banking compensation by its affiliates if the member has implemented procedures prescribed by NASD Rule 2711(h)(2)(v)(b) and NYSE Rule 472(k)(1)(iii)a.2. Under these provisions, a member is not required to disclose an affiliate's non-investment banking compensation from a subject company if the member maintains and enforces policies and procedures to wall off research analysts and employees with ability to influence the substance of research reports from receiving information about such compensation.

Finally, a member must disclose if the subject company is or has been during the preceding 12-month period a client of the member. In such cases, the member also must disclose the types of services provided to the subject company, categorized as either investment banking services, non-investment banking securities-related services, or non-securities services.

The SROs will not require a member that distributes third-party research to separately disclose non-investment banking compensation received by the member or an affiliate, unless receipt of that compensation represents an actual, material conflict of interest of the member known at the time of the distribution of the research report. Similarly, a member need not disclose the existence of a client relationship with the subject company, unless such relationship already falls within the current Third-Party Research Disclosures, such as managing or co-managing a public offering of the subject company within the previous 12 months. In sum, members are required to make the same disclosures under the SRO Rules when distributing third-party research as they were required to make prior to the July 2003 Amendments, recognizing that the receipt of non-investment banking compensation can, under certain circumstances, represent a material conflict of interest.

Member vs. Third-Party Research Report

The determination of whether a research report is considered a product of the member or of a third party depends on: (1) whether the report appears to be the product of a member or (2) whether a "research analyst" (as defined by the SRO Rules) associated with a member is involved in producing the research report. It is irrelevant to the analysis where a report is distributed -- domestically or internationally -- or to whom it is distributed, or on which market the subject company's securities are traded.

The SROs consider research reports that meet either of these above factors to be reports produced by the member that must meet all of the SRO Rules' requirements. Thus, for example, if a member issues a "globally-branded"[14] research report, all of the SRO Rules would apply to that report. Similarly, if a member adapts, alters or distributes a research report produced by an affiliate or an independent third party in such a way that an investor reasonably could believe it to be the product of the member, rather than that of the affiliate or independent third party, then

[14] A "globally-branded" research report refers to the use of a single marketing identity that encompasses the member and its affiliates.

the report will be considered to be the member's own and subject to all of the SRO Rules. A research report prepared by a "mixed research team" that includes at least one person who meets the definition of "research analyst" and is associated with the member also would be considered a report produced by the member.

Independent and Non-Member Affiliate Research Reports

A research report distributed by a member that is produced either by an independent third party or non-member affiliate must include the Third-Party Research Disclosures. In this regard, the interpretations of the SRO Rules treat independent third-party research and non-member affiliate research the same, with one exception. A member that makes a non-member affiliate's research report available to its customers upon request or through its website or a website maintained by the member must include the Third-Party Research Disclosures. However, these disclosures do not apply to independent third-party research that is similarly made available to customers upon request or through a member-maintained website.

Subject Company Review of Research

The SRO Rules require legal or compliance personnel (the "Gatekeepers") to intermediate certain communications between a member's Research Department and companies that are the subject of a research report. Specifically, the SRO Rules[15] provide:

- That a member **may not submit a research report to the subject company prior to publication**, except for the **review of sections of a draft** of the research report solely to verify facts. Members may not, under any circumstances, provide the subject company sections of research reports that include the research summary, the research rating or the price target.

- Prior to **submitting any sections of the research report to the subject company,** the Research Department must provide a complete draft of the research report to the Legal or Compliance Department.

- If after submission to the subject company, the Research Department intends to change the proposed rating or price target, **the Research Department must provide written justification to, and receive prior written authorization from, the Legal or Compliance Department for any change.** The Legal or Compliance Department must retain copies of any drafts and changes thereto of the research reports provided to the subject company.

The SRO Rules prohibit the submission of a research report, in its entirety, to the subject company prior to its publication, even if the research summary, research rating or price

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15 NASD Rule 2711(c) and NYSE Rule 472(b)(4).

target has been redacted from the report. Providing a report with such information redacted could still enable a subject company to discern the tenor of the report and possibly the company's rating or even price target. The rules only permit submission of sections of a report to verify facts in that section. Submission of facts interspersed with opinions, estimates, conclusions and other non-factually based information by the research analyst violates the SRO Rules. Members should consider submitting to the subject company a separate document containing a summary of facts for which the member seeks verification.

The SROs also wish to clarify the role of the Gatekeepers for purposes of these Rules. Gatekeepers may not merely rubberstamp changes in research reports after sections of the report have been submitted to the subject company. Gatekeepers must review the report and changes thereto, and document the basis for approval. In instances where a change in a rating or price target is to be made, the Gatekeepers must review the written justification provided by the research department, compare it with any comments received from the subject company regarding sections of the draft that had been submitted for factual verification, and conduct such follow-up inquiry as is necessary to establish a reasonable and causal basis for the change.

Restrictions on Publishing Research

Quiet Periods and Blackout Periods

The SRO Rules impose "quiet periods" during which a member may not publish a research report or make a public appearance regarding a subject company for which the member acted as manager or co-manager of a public offering of securities. The SRO Rules impose on managers and co-managers a 40 calendar-day quiet period following an initial public offering ("IPO"), and a 10 calendar-day quiet period (subject to certain exceptions) following a secondary offering.[16] The SRO Rules also impose a 25 calendar-day quiet period on members that have agreed to participate as an underwriter or dealer (other than as a manager or co-manager) of an issuer's IPO.[17]

The SRO Rules also prohibit a member that has acted as manager or co-manager of a securities offering from publishing a research report or making a public appearance concerning a subject company 15 days prior to or after the expiration, waiver or termination of a "lock-up" or similar agreement that restricts the sale of securities after the completion of a securities offering.[18] Finally, the SRO Rules impose a "blackout period" that prohibits a research analyst from purchasing or selling the securities of a company that the analyst follows for a period beginning 30 days before and ending 5 days after the publication of a research report on the subject company or a change in a rating or price target of the company's securities.[19]

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[16] NASD Rule 2711(f)(1) and NYSE Rule 472(f)(1) and (2).

[17] NASD Rule 2711(f)(2) and NYSE Rule 472(f)(3).

[18] NASD Rule 2711(f)(4) and NYSE Rule 472(f)(4).

[19] NASD Rule 2711(g)(2) and NYSE Rule 472(e)(2).

Exceptions to the Quiet Periods and Blackout Periods

The SRO Rules allow a member to publish a research report or make a public appearance during the restricted periods concerning the effects of significant news or a significant event that occurs during those periods, provided that the member's legal and compliance department authorizes publication of the report before it is issued or the public appearance before it is made.[20] Members have asked for additional guidance regarding this exception.

The significant news or event exception is intended to allow for coverage in research reports and public appearances of news or events that have a material impact on, or cause a material change to, a company's operations, earnings or financial condition, and that generally would trigger the filing requirements of SEC Form 8-K. Examples might include the rejection of a patent or drug application; a labor strike; resignation of a chief executive officer or chief financial officer; or a publicly-announced investigation into company activities by a regulator. Members have asked whether a subject company's announcement that it exceeded, met or fell short of expected earnings would constitute significant news permitting an exception to the quiet and blackout periods. As a general matter, the SROs would not regard an announcement about earnings to fall within the exception because an earnings announcement itself generally is not a causal event or news item that materially affects a company's operations, earnings or financial condition. There may be cases, however, where significant news or a significant event has caused the company to exceed or fall short of expected earnings that may permit an exception and allow a member to issue a research report within the quiet or blackout period to the extent that it discusses the news item that affected earnings.

Additionally, members have inquired whether the SRO Rules are intended to limit the content of a research report that is issued during a quiet or blackout period due to a significant event or news item to the effects of the event or news, or whether such a report may discuss any other issues related to the subject company. A research report issued pursuant to this exception must be limited to discussing the effects of the news or event that triggered the exception. However, the report may contain or update a price target, rating or recommendation concerning the subject company's securities.

Members also have inquired whether the private placement of a subject company's equity would be a significant event that would allow an exception from the SRO Rules' quiet period provisions. In general, the SROs would not regard the issuance of such securities as a significant event allowing a member to publish research during a quiet period. The private placement of securities is within the issuer's control, and thus not the sort of unforeseen news or event that the SRO Rules contemplated in allowing an exception to the quiet periods.

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[20] NASD Rules 2711(f)(1)(B)(i), 2711(f)(4) and 2711(g)(2)(B), and NYSE Rules 472(e)(4)(ii) and 472(f)(5).

Application of Quiet Periods to Unregistered Offerings

Members further have asked whether the rules imposing quiet periods following secondary offerings and before and after waivers of lock-up agreements apply to non-registered securities offerings. In general, the quiet period following a secondary offering and before and after the waiver of a lock-up agreement applies only to offerings of securities that must be registered for offer or sale in the United States. Thus, quiet periods would not apply to private placements of Rule 144A securities and Regulation S offerings.

Lock-up Agreements and Waivers

Finally, members have inquired as to what date a lock-up agreement is considered waived for purposes of applying the 15-day quiet period before and after the waiver of a lock-up agreement. The 15-day quiet period is triggered based on the first date a shareholder that is subject to a lock-up agreement may sell his or her shares pursuant to the waiver. It is *not* triggered based on the date when an underwriter or other party notifies shareholders that a waiver has been granted. It is also not triggered based on the date when an underwriter or other party registers a securities offering under the federal securities laws.

Since SRO rules do not require lock-up agreements, and since parties to such agreements often are outside the jurisdiction of the NASD or NYSE, the SROs typically cannot determine whether a specific act or contractual provision in a lock-up agreement constitutes a waiver for the purposes of the SRO quiet periods. However, the SROs remind members that the purpose of the quiet period is to prevent members from publishing favorable research that is intended to drive up the price of an issuer's stock for the benefit of certain shareholders who will no longer be subject to a lock-up agreement. Accordingly, the SROs will closely examine research that is issued or otherwise distributed around the time that an underwriting client of the member sells, or first becomes eligible to sell, a significant volume of the subject company's shares.

Personal Trading Restrictions

Members have raised a number of issues with regard to the application of the personal trading restrictions under the SRO Rules.[21]

Trading Against Recommendations

The SRO Rules generally prohibit a research analyst account[22] from purchasing or selling any security or option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the

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21 NASD Rule 2711(g) and NYSE Rule 472(e).

22 A "research analyst account" includes any account in which a research analyst or member of the research analyst's household has a financial interest, or over which the analyst has discretion or control, other than an investment company registered under the Investment Company Act of 1940. NASD Rule 2711(a)(6). *See also* NYSE Rule 472.40.

member.[23] Members have inquired as to whether this restriction applies only to recommendations regarding securities of the subject companies covered by the research analyst making the trade, or whether this restriction applies to the recommendations regarding all subject companies covered by the member. This restriction only applies to trades in securities of subject companies covered by the particular research analyst.

Dividend Reinvestment Programs

Members have inquired whether the SROs regard purchases of securities through a dividend reinvestment plan ("DRIP") to be subject to the "blackout periods" on personal trading. The SRO Rules generally prohibit a research analyst account from purchasing or selling any security issued by a company that the research analyst follows, or any option on or derivative of such security, for a period beginning 30 calendar days before and ending 5 calendar days after the publication of a research report concerning the company or a rating or price target of the company's securities.

DRIPs typically are plans that allow a participant to reinvest dividends paid on securities held by the participant in the same class of securities of the issuer. Most DRIPs have two components. First, they automatically reinvest cash dividends in the purchase of additional shares of the same securities held by the participant. Second, they permit periodic discretionary cash investments in the same securities. The SROs would not regard automatic reinvestments of dividends in securities of a subject company as covered by the personal trading restrictions' blackout periods. The SROs would reach the same conclusion with respect to automatic reinvestments of dividends in investment funds that are subject to the personal trading restrictions.[24] However, any discretionary cash investments in a subject company's securities, or securities of an investment fund that is subject to the personal trading restrictions, that are made through a DRIP would be subject to the blackout periods.

Short Sales

Where a research analyst has a "sell" (or similar) rating on a subject company's securities, establishes a short position with regard to the securities and later covers the short position, the SROs would regard the covering of the short position as trading contrary to his or her recommendation, since as part of that transaction the analyst would have to buy the securities. Moreover, an analyst may not establish a short position on a rated security during an applicable blackout period.

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[23] NASD Rule 2711(g)(3) and NYSE Rule 472(e)(3).

[24] The SRO Rules exclude from the personal trading restrictions investments in registered diversified investment companies and other investment funds that meet certain criteria. *See* NASD Rule 2711(g)(5) and NYSE Rule 472(e)(4)(v) and (vi).

Trades During "Neutral" Ratings

Some members have inquired whether a research analyst may buy or sell a subject company's securities if the analyst has assigned a "neutral" or "market perform" (or similar) rating to such securities. The SROs regard these (or similar) ratings as the same as a "hold" rating. Accordingly, a research analyst may neither buy nor sell a subject company's securities to which he or she has assigned a hold (or similar) rating.

Changes in Earnings Estimates

Several members have inquired whether the personal trading blackout period would be triggered if a research analyst changed his or her earnings estimates for a subject company, assuming that the change did not coincide with the issuance of a new research report and did not result in a change in the rating or price target for the subject company's securities. These circumstances would not trigger the personal trading blackout period.

Trading Restrictions on Supervisors of Research Analysts

The SRO Rules now require a member's legal or compliance personnel to pre-approve all transactions of persons who oversee research analysts to the extent such transactions involve equity securities of subject companies covered by the research analysts that they oversee.[25] The SRO Rules also have been amended to make clear that the research analyst personal trading restrictions do not apply to "blind trusts" that are controlled by a person other than the research analyst or a member of the analyst's household where neither the analyst nor a household member knows of the account's investments or transactions.[26] Likewise, the requirements for legal or compliance personnel to pre-approve securities transactions of supervisory personnel do not apply to transactions within "blind trusts" of which supervisory personnel are the beneficiaries.

The SROs have been asked how the requirement that legal or compliance personnel pre-approve the trades of supervisory personnel applies to an account that is managed by a third party (either an outside manager or an in-house account). As a general matter, the SROs would consider a member to have met its obligations to pre-approve a supervisor's transactions in a managed account where the supervisor has no discretion or control if the member has policies and procedures to monitor the managed account's trades. If such policies and procedures are in place, the SROs would not require legal or compliance personnel to pre-approve each transaction made within the managed account.

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[25] NASD Rule 2711(g)(6) and NYSE Rule 472(e)(5).

[26] NASD Rule 2711(a)(6) and NYSE Rule 472.40.

Disclosure Issues

In reviewing members' research reports, the SROs have found that some reports fail adequately to make the disclosures required by the SRO Rules.[27] This section of the joint memorandum is intended to highlight some of the more common problems that the SROs have found.

Prominence of Disclosures

The first page of a research report must include the disclosures required under the SRO Rules or must refer the reader to the pages on which such disclosures are found. Disclosures, and references to disclosures, must be clear, comprehensive and prominent.[28]

References on the front page of a research report to where disclosures are located must be separated from the report's body text, and in larger font size than the body text. For example, many firms are enclosing the references to disclosure location in a box on the first page of the report that enhances the prominence of the disclosure reference.

A notation on the first page that refers readers to the "end of the report" rather than the specific page is not sufficient. The SRO Rules require a reference to the specific page number or to the last page of the report or to a specific section of the report, such as the appendix. In addition, members may use hyperlinks to direct the reader to the required disclosures only in electronically transmitted reports and compendium reports[29] or as an additional point of reference in written reports.

Regardless of where the required disclosures are placed, they should be labeled using a heading such as "Important Disclosures" or "Required Disclosures" so as to be clearly identifiable. Similarly, the font size of the type must be large enough so that the disclosures are clearly legible and distinguishable from body text, other disclosures or disclaimers.

The "Important (or Required) Disclosures" section must include all applicable required textual disclosures (e.g., market making, ownership positions, compensation, etc.), the price chart, the ratings description, ratings distribution (by number of investment banking clients), the valuation methodology, price target and related risk factors description, in a clear and logical order. As an example, related disclosures such as ratings systems and ratings distributions should be in close proximity.

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[27] See NASD Rule 2711(h) and NYSE Rule 472(k)(1).

[28] NASD Rule 2711(h)(10) and NYSE Rule 472(k)(1).

[29] A "compendium report" is a research report that covers six or more subject companies. See NASD Rule 2711(h)(11) and NYSE Rule 472(k)(1).

Disclosure of Officer or Director Positions

A member is required to disclose in research reports if the research analyst or member of his or her household is an officer, director, or advisory board member of the recommended issuer.[30] This disclosure, if applicable, must include the position held by the research analyst or household member.

Conditional or Indefinite Language

Members are required to disclose in research reports if they own 1% or more of a subject company's equity securities and if they make a market in a subject company's securities at the time the research report is issued. Members also must disclose if the member or its affiliates: (a) managed or co-managed a public offering of equity securities for the subject company in the past twelve months; (b) received compensation for investment banking services from the subject company in the past twelve months; or (c) expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.[31]

Members may not use conditional or indefinite language in required disclosures, such as "may have a position" or "may make a market" in any of the subject company's securities, or that the reader "should assume" that the firm or its affiliates engaged in investment banking business with a subject company. The required disclosures with respect to past receipt and expectation of investment banking services related compensation must be made separately, if applicable. For example, a member may not disclose that it "received compensation for investment banking services in the past twelve months *or* expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months." Such disclosure lacks the specificity required by the SRO Rules.

Use of Disclaimers

Research reports may not include general or specific disclaimers that contradict or are inconsistent with disclosures required by SRO Rules. For example, it is inconsistent for a research report to disclose that the member makes a market in the specific securities that are the subject of the research report and separately to disclose generally that the member may make a market in some or all of the securities mentioned in the report.

The presence of disclosures and disclaimers not required by the SRO Rules in close proximity to the disclosures required by the SRO Rules may cause confusion and detract from their readability. Therefore, any disclosures or disclaimers not required by the SRO Rules must be clearly separated and appropriately labeled. If the required disclosures are placed near non-required disclaimers and disclosures, each set of disclosures and

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[30] NASD Rule 2711(h)(3) and NYSE Rule 472(k)(1)(iii)c.

[31] NASD Rule 2711(h)(1)(B), (h)(2)(A)(ii), and (h)(8); NYSE Rule 472(k)(1)(i)a., b., and c.

disclaimers must be clearly labeled, e.g., "Important (or Required) Disclosures," "Other Disclosures," and "Disclaimers." The disclosures required by the SRO Rules also must be separate from disclosures required by foreign jurisdictions.

Use of Stock Symbols

Members may not use stock symbols in the "Important Disclosures" section of the report unless the reader is specifically directed to where in the report the subject companies represented by the symbols are identified by proper names.

Disclosure of Ratings Distributions and Price Charts

The SRO Rules allow members to use any ratings system they deem appropriate in their research reports, so long as they are accompanied by a clear definition of the meaning of each rating used in the system.[32] The SRO Rules require a member to disclose in each research report the percentages of all securities rated by the member to which the member has assigned a "buy", "hold/neutral" or "sell" rating.[33] The SRO Rules also require each report to disclose the percentage of subject companies within each of these three rating categories for whom the member has provided investment banking services within the previous 12 months.[34]

If a member utilizes a ratings system that employs terms different than "buy," "hold/neutral" and "sell," the member must determine, based on its own ratings system, into which of these three categories its ratings fall. The research report must use the terms "buy," "hold" and "sell" in making these ratings distributions disclosures. However, if a member uses a ratings system that employs terms other than "buy," "hold/neutral" and "sell," the member may combine its own ratings terms with those categories required by the SRO Rules to make the ratings distribution disclosures (*e.g.*, "buy/overweight," "hold/equalweight and "sell/underweight").

The SRO Rules specify that information regarding ratings distributions must be current as of the most recent calendar quarter end (or the second most recent calendar quarter end if the publication date is less than 15 days after the most recent calendar quarter).[35] The SRO Rules do not specify, however, what time period the ratings distribution must cover. Some members have noted that they do not regularly issue ratings and thus were uncertain as to how far back the ratings distribution universe must extend. In general, the ratings distribution should include all current ratings of the member. However, if the member does not issue new ratings on a relatively frequent basis, the SROs will consider a member to

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[32] NASD Rule 2711(h)(4) and NYSE Rule 472(k)(1)(i)f.

[33] NASD Rule 2711(h)(5)(A) and NYSE Rule 472(k)(1)(i)g. and 472.70.

[34] NASD Rule 2711(h)(5)(B) and NYSE Rule 472(k)(1)(i)g. and 472.70.

[35] NASD Rule 2711(h)(5)(C) and NYSE Rule 472.70.

have complied with the ratings distribution disclosure requirements if the distribution includes ratings that the member has issued within the past 12 months.

If a research report does not contain any rating – express or implied – of the subject company's stock, the report is not required to include the ratings distribution information required by the SRO Rules. In addition, if the report does not include either a rating or a price target for the subject company's stock, the report is not required to include a price chart.[36]

[36] See NASD Rule 2711(h)(6) and NYSE Rule 472(k)(1)(i)h.

Comparison of Global Settlement and SRO Rules		
Subject	**Global Settlement**	**SRO Rules**
Reporting Lines	**Undertaking I.1**	**NASD Rule 2711(b)(1) and NYSE Rule 472(b)(1)**
	Research may not report directly or indirectly through investment banking. Head of research may report to person to whom investment banking head also reports, provided that such person has no direct responsibility for investment banking activities.	No research analyst may be subject to the supervision or control of any employee of the member's investment banking department, and no person engaged in investment banking activities may have any influence or control over the compensatory evaluation of a research analyst.
Definition of "Research Report"	**Undertaking I.1.e**	**NASD Rule 2711(a)(8) and NYSE Rule 472.10(2)**
	Limited to communications to U.S. investors. Excludes quantitative analysis concerning sectors, industries or indexes. Also excludes analyses for current customers (without limit).	Not limited to communications to U.S. investors. Does not exclude quantitative analyses, although interpretations exclude analyses of sectors, industries or indexes. Current customer analysis exclusion limited to 15 customers.
Legal/Compliance	**Undertaking I.2**	**N/A**
	Research must have its own dedicated legal and compliance staff, who may be part of the firm's overall compliance/legal infrastructure.	No similar requirement.
Budget	**Undertaking I.3**	**NASD Rules 2711(d)(2) and (h)(2)(A)(i)(a) and NYSE Rules 472(h)(2) and (k)(1)(ii)a.2**
	Research budget must be determined by senior management without input from investment banking, and without regard to investment banking revenues. Firm revenues as a whole may be considered. Audit Committee must ensure compliance with this provision annually.	A firm's overall profitability may be considered in determining the compensation component of a firm's research budget, but this component may not be based on profitability of firm's investment banking department or division. In addition, if a research analyst's compensation is based upon the firm's overall profitability which includes investment banking revenues, this fact must be disclosed.
Physical Separation	**Undertaking I.4**	**N/A**
	Research and investment banking must be physically separated.	No similar requirement.

Subject	Global Settlement	SRO Rules
Compensation	**Undertaking I.5**	**NASD Rule 2711(d) and NYSE Rule 472(h)**
	Compensation of research personnel must be determined exclusively by research management and firm's senior management based on following principles: (A) Investment banking will have no input. (B) Compensation may not be based on IB revenues or results (firm results OK). (C) A significant portion of the lead analyst's compensation must be based on the quality and accuracy of the lead analyst's research, analysis, ratings and price targets. (D) Certain other factors may be taken into consideration. (E) Compensation criteria determined by research management and firm's senior management (not including IB) and set forth in writing in advance. (F) Research management must document the basis for such compensation. Compensation committee of firm's parent company will conduct annual compliance review.	Analysts may not receive compensation based on a specific investment banking transaction. Lead analysts' compensation must be reviewed and approved by a compensation committee that does not have any representation from the IB department. The committee must consider the following factors: (A) the analyst's individual performance, including his productivity and the quality of his research; (B) the correlation between the analyst's recommendations and the stock price performance; and (C) the overall ratings received from clients, sales force, and peers independent from the firm's IB department, and other independent ratings services. The analyst's contributions to IB department may not be considered. Documentation and attestation requirements.
Evaluations	**Undertaking I.6**	**NASD Rule 2711(d)(2) and NYSE Rule 472(h)(2)**
	Evaluations of research personnel will not be done by, nor will there by input from, investment banking.	Research analyst compensation review committee may not have representation from investment banking.
Coverage	**Undertaking I.7**	**NASD Rules 2711(b)(1) and (b)(3)(A) and NYSE Rules 472(b)(1) and (b)(3)(i)**
	Investment banking will have no input into company-specific coverage decisions (initiation or termination), and IB revenues will not be taken into account in making company-specific coverage decisions. Provision does not apply to industry sector coverage decisions.	No research analyst may be subject to the supervision or control of any employee of a member's investment banking department. In addition, any discussion regarding research coverage would have to be intermediated by legal and compliance.
Termination of Coverage	**Undertaking I.8**	**NASD Rule 2711(f)(5) and NYSE Rule 472(f)(6)**
	Requires a firm to provide a final research report when it decides to terminate coverage of a particular company. Firm must use the same means of disseminating the final report that it ordinarily uses. No final report is required if the prior coverage was purely quantitative. The report must be comparable to prior reports, unless impracticable. The report must disclose notice of termination and the rational for the decision to terminate coverage.	Requires notice of termination if a member intends to terminate coverage of a subject company. Firm must use the same means of disseminating the final report that it ordinarily uses. The report must be comparable in scope and detail to prior reports and must include a final rating or recommendation unless impracticable. If impracticable to produce a final rating or recommendation, report must disclose the rationale for the decision to terminate coverage.

Subject	Global Settlement	SRO Rules
Prohibition on Soliciting Investment Banking Business	**Undertaking I.9**	**NASD Rule 2711(c)(4) and NYSE Rule 472(b)(5)**
	Research is prohibited from participating in efforts to solicit IB business. Among other things, research may not participate in pitches with prospective IB clients or have other communications with companies for the purpose of soliciting IB business.	Same rule.
Firewalls Between Research and Investment Banking	**Undertaking I.10**	**NASD Rules 2711(b)(2) and (b)(3) and NYSE Rules 472(b)(2) and (b)(3)**
	Sets forth detailed "firewall" restrictions regarding communications between research and investment banking during the period that research is assisting IB in selecting prospective IB clients. Allows research personnel to assist in confirming the adequacy of disclosures in offering documents and pricing of transactions subject to certain conditions. Allows research to attend widely attended conferences and firm meetings at which matters of general firm interest are discussed. Allows IB and research to discuss compliance issues in presence of internal compliance personnel. Allows communications between IB and research personnel not related to IB or research without restriction.	Generally requires written or oral communications between non-research and research personnel regarding the content of a research report to be documented and conducted through or in the presence of legal or compliance personnel. Non-research personnel may only review a research report to verify its factual accuracy or to identify potential conflicts of interest.
Road Shows	**Undertaking I.11**	**NASD Rules 2711(c)(5) and (c)(6) and NYSE Rules 472(b)(6)**
	Prohibits research personnel from participating in company or investment banking-sponsored road shows related to a public offering or other IB transaction. IB is prohibited from directing research personnel to engage in marketing or selling efforts to investors with respect to an IB transaction.	Same rule. Also prohibits research analysts from communicating with customers regarding investment banking transactions in presence of IB personnel or company management. Research analyst communications with customers or internal personnel regarding IB transactions must be fair and balanced.

Subject	Global Settlement	SRO Rules
Oversight	**Undertaking I.12**	**N/A**
	Requires firms to create an oversight committee of research management to review changes in ratings or price targets, review reports to determine whether changes in ratings or price targets should be considered, and to monitor overall research report quality. Exceptions for quantitative analysis.	No similar requirement.
Disclosure	**Undertaking II.1**	**NASD Rule 2711(h) and NYSE Rule 472(k)(1)**
	Requires firms to disclose on first page of a research report, in addition to other disclosures required by rule, that firm does or seeks to do business with companies covered by its reports and that as a result, investors should be aware that conflicts of interest could affect the report's objectivity. Requires disclosure of availability of independent research for listed companies. Must disclose that investors should consider the report only as a single factor in making their investment decision.	The SRO Rules have more specific and comprehensive disclosure requirements than these. For example, the SRO Rules require a firm to disclose if it or an affiliate (a) managed or co-managed a public offering of securities for the subject company in the last 12 months, (b) received investment banking compensation from the subject company in the past 12 months, or (c) expects to receive or intends to seek investment banking compensation from the subject company in the next 3 months.
Transparency of Analysts' Performance	**Undertaking II.2**	**NASD Rules 2711(h)(4), (5) and (6) and NYSE Rules 472(k)(1)(i)(f), (g), and (h)**
	Requires firms to make available on their web sites after the conclusion of each quarter certain information regarding the analyst's research for each subject company, such as the date of the report, rating, price target, period within which price target is to be achieved, EPS forecast, and definitions of ratings.	Research analysts must disclose in research reports the meanings of the ratings used in the firm's ratings system, a percentage distribution of the buy, hold and sell ratings that the firm assigns to subject companies it covers, including the percentage of these companies that are firm IB clients, and a price chart that shows the movement of the subject company's stock price and the dates on which the analyst assigned or changed a rating or price target.
Investor Education	**Undertaking II.3**	**N/A**
	Requires firms to pay fine to pay for investor education pursuant to plan administered by SEC, NASD and NYSE, with remainder going to NASAA for same purpose.	No similar requirement.

Subject	Global Settlement	SRO Rules
Applicability	**Undertaking II.4**	**NASD Rule 2711(a)(8) and NYSE Rule 472.10(2)**
	Applies Undertaking restrictions only to research reports that are prepared by the firm and that related to either a U.S. company or a non-U.S. company for which the U.S. is a principal equity trading market. Applies coverage and disclosure requirements, above, to any report furnished by a firm to U.S. investors.	Definition of "research report" does not contain this limitation; thus, it includes research on non-U.S. companies. The SRO Rules require limited disclosures for reports prepared by foreign affiliates and other third-party research distributed to customers.
Policies and Procedures	**Undertaking II.5**	**NASD Rule 2711(i) and NYSE Rule 472(c)**
	Prohibits a firm from knowingly doing indirectly that which it cannot do directly under the Undertaking. Requires firms to adopt policies and procedures reasonably designed to ensure that a firm's associated persons do not seek to influence the contents of research reports for the purpose of obtaining investment banking business. Policies must instruct firm personnel to report violations of this proscription.	Members must adopt and implement procedures reasonably designed to ensure the member and its employees comply with the SRO Rules. Senior officer must attest that the member has adopted and implemented these procedures.
Independent Monitor	**Undertaking II.7**	**N/A**
	Requires each firm to retain at its own expense an independent monitor to review implementation of the Undertaking. Sets forth detailed rules governing how independent monitor will work.	No similar requirement.
Independent, Third-Party Research	**Undertaking III**	**N/A**
	Sets forth detailed requirements for firms to procure and make available for their clients independent research on listed companies that they cover (other than quantitative research).	No similar requirement.
Restrictions on Communications with the Subject Company	**N/A**	**NASD Rule 2711(c)(1) and (c)(2) and NYSE Rule 472(b)(4)**
	No similar provisions.	Members may not submit research reports to subject companies before their publication except to review the factual accuracy of a report, and subject to conditions.

Subject	Global Settlement	SRO Rules
Prohibitions on Promises of Favorable Research	**N/A**	**NASD Rule 2711(e) and NYSE Rule 472(g)(1)**
	No similar provisions.	Members may not offer favorable research or a specific rating or price target, or threaten to change any research, rating or price target to induce the receipt of business or compensation.
Restrictions on Publishing Research	**N/A**	**NASD Rules 2711(f)(1), (2), (3) and (4) and NYSE Rules 472(f)(1), (2), (3), (4) and (5)**
	No similar provisions.	Members are subject to "quiet periods" during which they may not publish research and analysts may not make public appearances following initial and secondary offerings and around the termination, waiver or expiration of "lock-up" agreements, subject to certain exceptions.
Restrictions on Personal Trading by Analysts	**N/A**	**NASD Rule 2711(g) and NYSE Rule 472(e)**
	No similar provisions.	Research analysts face a number of restrictions on the trading of securities that they cover, such as prohibitions on trading against recommendations and trading blackouts around the time research is issued or ratings are changed.
Disclosure Requirements for Analyst Public Appearances	**N/A**	**NASD Rule 2711(h) and NYSE Rule 472(k)(2)**
	No similar provisions.	Research analysts must make disclosures when discussing stocks in public appearances, such as whether the member has received investment banking compensation from the issuer or the analyst has a financial interest in the issuer.
Other Disclosure Requirements for Research Reports	**N/A**	**NASD Rule 2711(h) and NYSE Rule 472(k)(1)**
	No similar provisions.	Members must disclose in research reports firm and analyst ownership of subject company securities and receipt of non-investment banking compensation from subject company.
Retaliation Against Analysts	**N/A**	**NASD Rule 2711(j) and NYSE Rule 472(g)(2)**
	No similar provisions.	Members are prohibited from retaliating against or threatening analysts as a result of adverse or unfavorable research or public appearance written or made by the analyst.
Registration of Research Analysts	**N/A**	**NASD Rule 1050 and NYSE Rules 344 and 473**

Subject	Global Settlement	SRO Rules
	No similar provisions.	Research analysts must pass qualification exams (Series 86/87) and register with their members' SRO. Certain exceptions for foreign and technical analysts.
Analyst Continuing Education Requirements	**N/A**	**NASD Rule 1120 and NYSE Rule 345A**
	No similar provisions.	Research analysts and their supervisors must satisfy certain continuing education requirements.

Exhibit 5

Exhibit 5 shows the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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Text of Proposed New FINRA Rule

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2242. Debt Research Analysts and Debt Research Reports

(a) Definitions

For purposes of this Rule, the following terms shall be defined as provided.

(1) "Debt research analyst" means an associated person who is primarily responsible for, and any associated person who reports directly or indirectly to a debt research analyst in connection with, the preparation of the substance of a debt research report, whether or not any such person has the job title of "research analyst."

(2) "Debt research analyst account" means any account in which a debt research analyst or member of the debt research analyst's household has a financial interest, or over which such analyst has discretion or control. This term shall not include an investment company registered under the Investment Company Act over which the debt research analyst or a member of the debt research analyst's household has discretion or control, provided that the debt research analyst or member of a debt research analyst's household has no financial interest in such investment company, other than a performance or management fee. The term also shall not include a "blind trust" account that is controlled by a person other than the debt research analyst or member of the debt

research analyst's household where neither the debt research analyst nor a member of the debt research analyst's household knows of the account's investments or investment transactions.

(3) "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 communications that solely constitute an equity research report as defined in Rule 2241(a)(11). In general, this term shall not include:

(A) communications that are limited to the following, if they do not include an analysis of, or recommend or rate, individual debt securities or issuers:

(i) discussions of broad-based indices;

(ii) commentaries on economic, political or market conditions;

(iii) commentaries on or analyses of particular types of debt securities or characteristics of debt securities;

(iv) technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price;

(v) recommendations regarding increasing or decreasing holdings in particular industries or sectors or types of debt securities; or

(vi) notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent debt research report on the subject company that includes all current applicable disclosures required by this Rule and that such debt research report does not contain materially misleading disclosure, including disclosures that are outdated or no longer applicable;

(B) the following communications, even if they include an analysis of an individual debt security or issuer and information reasonably sufficient upon which to base an investment decision:

(i) statistical summaries of multiple companies' financial data, including listings of current ratings that do not include an analysis of individual companies' data;

(ii) an analysis prepared for a specific person or a limited group of fewer than 15 persons;

(iii) periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual debt securities in the context of a fund's or account's past performance or the basis for previously made discretionary investment decisions; or

(iv) internal communications that are not given to current or prospective customers; and

(C) communications that constitute statutory prospectuses that are filed as part of the registration statement.

(4) "Debt security" means any "security" as defined in Section 3(a)(10) of

the Exchange Act, except for any "equity security" as defined in Section 3(a)(11) of the Exchange Act, any "municipal security" as defined in Section 3(a)(29) of the Exchange Act, any "security-based swap" as defined in Section 3(a)(68) of the Exchange Act, and any "U.S. Treasury Security" as defined in paragraph (p) of Rule 6710.

(5) "Debt trader" means a person, with respect to transactions in debt securities, who is engaged in proprietary trading or the execution of transactions on an agency basis.

(6) "Independent third-party debt research report" means a third-party debt research report, in respect of which the person producing the report:

(A) has no affiliation or business or contractual relationship with the distributing member or that member's affiliates that is reasonably likely to inform the content of its research reports; and

(B) makes content determinations without any input from the distributing member or that member's affiliates.

(7) "Institutional investor" means any person that satisfies the requirements of paragraph (j)(1)(A) or (B) of this Rule.

(8) "Investment banking department" means any department or division, whether or not identified as such, that performs any investment banking service on behalf of a member.

(9) "Investment banking services" include, without limitation, acting as an underwriter, participating in a selling group in an offering for the issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a

financial adviser in a merger or acquisition; providing venture capital or equity lines of credit or serving as placement agent for the issuer or otherwise acting in furtherance of a private offering of the issuer.

(10) "Member of a debt research analyst's household" means any individual whose principal residence is the same as the debt research analyst's principal residence. This term shall not include an unrelated person who shares the same residence as a debt research analyst, provided that the debt research analyst and unrelated person are financially independent of one another.

(11) "Public appearance" means any participation in a conference call, seminar, forum (including an interactive electronic forum) or other public speaking activity before 15 or more persons or before one or more representatives of the media, a radio, television or print media interview, or the writing of a print media article, in which a debt research analyst makes a recommendation or offers an opinion concerning a debt security or an issuer of a debt security. This term shall not include a password protected Webcast, conference call or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current debt research report or other documentation that contains the required applicable disclosures, and that the debt research analyst appearing at the event corrects and updates during the event any disclosures in the debt research report that are inaccurate, misleading or no longer applicable.

(12) "Qualified institutional buyer" has the same meaning as under Rule 144A of the Securities Act.

(13) "Retail investor" means any person other than an institutional

investor.

(14) "Research department" means any department or division, whether or not identified as such, that is principally responsible for preparing the substance of a debt research report on behalf of a member.

(15) "Subject company" means the company whose debt securities are the subject of a debt research report or a public appearance.

(16) "Third-party debt research report" means a debt research report that is produced by a person or entity other than the member.

(b) Identifying and Managing Conflicts of Interest

(1) A member must establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to:

(A) the preparation, content and distribution of debt research reports;

(B) public appearances by debt research analysts; and

(C) the interaction between debt research analysts and those outside of the research department, including investment banking department personnel, sales and trading personnel, principal trading personnel, subject companies and customers;

(2) A member's written policies and procedures must be reasonably designed to promote objective and reliable debt research that reflects the truly held opinions of debt research analysts and to prevent the use of debt research reports or debt research analysts to manipulate or condition the market or favor the interests of

the member or a current or prospective customer or class of customers. Such policies and procedures must at a minimum:

(A) prohibit prepublication review, clearance or approval of debt research reports by:

(i) investment banking personnel;

(ii) principal trading personnel; and

(iii) sales and trading personnel;

(B) restrict or prohibit prepublication review, clearance or approval of debt research reports by other persons not directly responsible for the preparation, content and distribution of debt research reports, other than legal and compliance personnel;

(C) restrict or limit input by investment banking department, sales and trading and principal trading personnel into debt research coverage decisions to ensure that research management independently makes all final decisions regarding the research coverage plan;

(D) limit supervision of a debt research analyst to persons not engaged in:

(i) investment banking services transactions (such persons shall also be precluded from input into the compensation of debt research analysts);

(ii) principal trading activities (such persons shall also be precluded from input into the compensation of debt research analysts); or

(iii) sales and trading;

(E) limit determination of the debt research department budget to senior management, excluding senior management engaged in investment banking services or principal trading activities, and without regard to specific revenues or results derived from investment banking. Revenues and results of the firm as a whole, however, may be considered in determining the debt research department budget and allocation of debt research department expenses. Nothing in this provision shall require a member to prohibit any personnel from providing to senior management input regarding the demand for and quality of debt research, including product trends and customer interests;

(F) prohibit compensation based upon specific investment banking services or specific trading transactions or contributions to a member's investment banking services or principal trading activities;

(G) require that the compensation of a debt research analyst who is primarily responsible for the substance of a research report be reviewed and approved at least annually by a committee that reports to a member's board of directors, or if the member has no board of directors, a senior executive officer of the member. This committee may not have representation from investment banking personnel or persons engaged in principal trading activities and must consider the following factors when reviewing a debt research analyst's compensation, if applicable:

(i) the debt research analyst's individual performance, including the analyst's productivity and the quality of the debt research analyst's research; and

(ii) the overall ratings received from customers and peers (independent of the member's investment banking department and persons engaged in principal trading activities) and other independent ratings services.

Sales and trading personnel, but not personnel engaged in principal trading activities, may provide input to debt research management into the evaluation of the debt research analyst in order to convey customer feedback; provided, however, that final compensation determinations must be made by research management, subject to review and approval by the committee described in this subparagraph (G).

The committee must document the basis upon which each such research analyst's compensation was established, including any input from sales and trading;

(H) establish information barriers or other institutional safeguards to ensure that debt research analysts are insulated from the review, pressure or oversight by persons engaged in:

(i) investment banking services;

(ii) principal trading or sales and trading activities; and

(iii) other persons who might be biased in their judgment or supervision;

(I) prohibit direct or indirect retaliation or threat of retaliation against debt research analysts by any employee of the member as the result of an adverse, negative, or otherwise unfavorable debt research report or public appearance written or made by the debt research analyst that may adversely affect the member's present or prospective business interests;

(J) restrict or limit debt research analyst account trading in securities, any derivatives of such securities and any fund whose performance is materially dependent upon the performance of securities covered by the debt research analyst, including:

(i) ensuring that debt research analyst accounts, supervisors of debt research analysts and associated persons with the ability to influence the content of debt research reports do not benefit in their trading from knowledge of the content or timing of a debt research report before the intended recipients of such debt research have had a reasonable opportunity to act on the information in the debt research report; and

(ii) providing that no debt research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent debt research report published by the member, and defining financial hardship circumstances, if any (e.g., unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account), in which the member will permit a debt research analyst account to trade in a manner inconsistent with such research analyst's most recently published recommendation;

(K) prohibit explicit or implicit promises of favorable debt research, a particular debt research rating or recommendation or specific debt research content as inducement for the receipt of business or compensation;

(L) restrict or limit activities by debt research analysts that can reasonably be expected to compromise their objectivity, including prohibiting:

(i) participation in pitches and other solicitations of investment banking services transactions; and

(ii) participation in road shows and other marketing on behalf of an issuer related to an investment banking services transaction;

(M) prohibit investment banking department personnel from directly or indirectly:

(i) directing a debt research analyst to engage in sales or marketing efforts related to an investment banking services transaction; and

(ii) directing a debt research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction;

(N) prohibit prepublication review of a debt research report by a subject company for purposes other than verification of facts.

(c) Content and Disclosure in Debt Research Reports

(1) A member must establish, maintain and enforce written policies and procedures reasonably designed to ensure that:

(A) purported facts in its debt research reports are based on reliable information; and

(B) any recommendation or rating has a reasonable basis and is accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation or rating.

(2) A member that employs a rating system must clearly define in each debt research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based. The definition of each rating must be consistent with its plain meaning.

(A) Irrespective of the rating system a member employs, a member must include in each debt research report that includes a rating the percentage of all debt securities rated by the member to which the member would assign a "buy," "hold" or "sell" rating.

(B) A member must disclose in each debt research report the percentage of subject companies within each of the "buy," "hold" and "sell" categories for which the member has provided investment banking services within the previous 12 months.

(C) The information required in paragraphs (c)(2)(A) and (B) of this

Rule must be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the publication date of the debt research report is less than 15 calendar days after the most recent calendar quarter.

(3) If a debt research report contains a rating for a subject company's debt security, and the member has assigned a rating to such debt security for at least one year, the debt research report must show each date on which a member has assigned a rating and the rating assigned on such date. The member must include this information for the period that the member has assigned any rating or for a three-year period, whichever is shorter.

(4) A member must disclose in any debt research report at the time of publication or distribution of the report:

(A) if the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, any option, right, warrant, future, long or short position), and the nature of such interest;

(B) if the debt research analyst has received compensation based upon (among other factors) the member's investment banking, sales and trading or principal trading revenues;

(C) if the member or any of its affiliates:

(i) managed or co-managed a public offering of securities for the subject company in the past 12 months;

(ii) received compensation for investment banking services from the subject company in the past 12 months; or

(iii) expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;

(D) if, as of the end of the month immediately preceding the date of publication or distribution of a debt research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month) the member or its affiliates have received from the subject company any compensation for products or services other than investment banking services in the previous 12 months;

(E) if the subject company is, or over the 12-month period preceding the date of publication or distribution of the debt research report has been, a client of the member, and if so, the types of services provided to the issuer. Such services, if applicable, shall be identified as either investment banking services, non-investment banking securities-related services or non-securities services;

(F) if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report;

(G) if the debt research analyst received any compensation from the subject company in the previous 12 months; and

(H) any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of the publication or distribution of a debt research report.

(5) A member or debt research analyst will not be required to make a disclosure required by paragraph (c)(4) of this Rule to the extent such disclosure would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.

(6) Except as provided in subparagraph (7), the disclosures required by this paragraph (c) must be presented on the front page of debt research reports or the front page must refer to the page on which the disclosures are found. Electronic debt research reports may provide a hyperlink directly to the required disclosures. All disclosures and references to disclosures required by this Rule must be clear, comprehensive and prominent.

(7) A member that distributes a debt research report covering six or more subject companies (a "compendium report") may direct the reader in a clear manner as to where the reader may obtain applicable current disclosures required by this paragraph (c). Electronic compendium reports must include a hyperlink to the required disclosures. Paper-based compendium reports must provide either a toll-free number to call or a postal address to request the required disclosures and also may include a web address of the member where the disclosures can be found.

(d) Disclosure in Public Appearances

(1) A debt research analyst must disclose in public appearances:

(A) if the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), and the nature of such interest;

(B) if, to the extent the debt research analyst knows or has reason to know, the member or any affiliate received any compensation from the subject company in the previous 12 months;

(C) if the debt research analyst received any compensation from the subject company in the previous 12 months;

(D) if, to the extent the debt research analyst knows or has reason to know, the subject company currently is, or during the 12-month period preceding the date of publication or distribution of the debt research report, was, a client of the member. In such cases, the debt research analyst also must disclose the types of services provided to the subject company, if known by the debt research analyst; or

(E) any other material conflict of interest of the debt research analyst or member that the debt research analyst knows or has reason to know at the time of the public appearance.

(2) A member or debt research analyst will not be required to make a disclosure required by this paragraph (d) to the extent such disclosure would reveal material non-public information regarding specific potential future investment banking transactions of the subject company.

(3) Members must maintain records of public appearances by debt research

analysts sufficient to demonstrate compliance by those debt research analysts with the applicable disclosure requirements in this paragraph (d). Such records must be maintained for at least three years from the date of the public appearance.

(e) Disclosure Required by Other Provisions

In addition to the disclosures required by paragraphs (c) and (d) of this Rule, members and debt research analysts must comply with all applicable disclosure provisions of Rule 2210 and the federal securities laws.

(f) Distribution of Member Research Reports

A member must establish, maintain and enforce written policies and procedures reasonably designed to ensure that a debt research report is not distributed selectively to trading personnel or a particular customer or class of customers in advance of other customers that the member has previously determined are entitled to receive the debt research report.

(g) Distribution of Third-Party Debt Research Reports

(1) A member may not distribute third-party debt research if it knows or has reason to know such research is not objective or reliable.

(2) A member must establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party debt research report it distributes contains no untrue statement of material fact and is otherwise not false or misleading. For the purposes of this paragraph (g)(2) only, a member's obligation to review a third-party debt research report extends to any untrue statement of material fact or any false or misleading information that:

(A) should be known from reading the debt research report;

or

(B) is known based on information otherwise possessed by the member.

(3) A member must accompany any third-party debt research report it distributes with, or provide a web address that directs a recipient to, disclosure of any material conflict of interest that can reasonably be expected to have influenced the choice of a third-party debt research report provider or the subject company of a third-party debt research report, including, at a minimum, the disclosures required by paragraphs (c)(4)(C), (c)(4)(F) and (c)(4)(H) of this Rule.

(4) A member shall not be required to review a third-party debt research report to determine compliance with paragraph (g)(2) of this Rule if such debt research report is an independent third-party debt research report.

(5) A member shall not be considered to have distributed a third-party debt research report for the purposes of paragraph (g)(3) where the research is an independent third-party debt research report and made available by a member (a) upon request; (b) through a member-maintained website; or (c) to a customer in connection with a solicited order in which the registered representative has informed the customer, during the solicitation, of the availability of independent debt research on the solicited debt security and the customer requests such independent debt research.

(6) A member must ensure that a third-party debt research report is clearly labeled as such and that there is no confusion on the part of the recipient as to the person or entity that prepared the debt research report.

(h) Exemption for Members with Limited Investment Banking Activity

The provisions of paragraphs (b)(2)(A)(i), (b)(2)(B), (b)(2)(C) (with respect to investment banking), (b)(2)(D)(i), (b)(2)(E) (with respect to investment banking), (b)(2)(G) and (b)(2)(H)(i) and (iii) of this Rule shall not apply to members that over 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; provided, however, that with respect to paragraph (b)(2)(H)(i) and (iii) of this Rule, such members must establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in investment banking services activities or other persons, including persons engaged in principal trading or sales and trading activities, who might be biased in their judgment or supervision. For the purposes of this paragraph (h), the term “investment banking services transactions” includes the underwriting of both corporate debt and equity securities but not municipal securities. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to paragraphs (b)(2)(A)(i), (b)(2)(B), (b)(2)(C), (b)(2)(D)(i), (b)(2)(E), (b)(2)(G) and (b)(2)(H)(i) and (iii) of this Rule.

(i) Exemption for Limited Principal Trading Activity

The provisions of paragraphs (b)(2)(A)(ii) and (iii), (b)(2)(B), (b)(2)(C) (with respect to sales and trading and principal trading), (b)(2)(D)(ii) and (iii), (b)(2)(E) (with respect to principal trading), (b)(2)(G) and (b)(2)(H)(ii) and (iii) of this Rule shall not apply to members where (1) in absolute value on an annual basis, the member’s trading gains or losses on principal trades in debt securities are $15 million or less over the previous three years, on average per year; and (2) the member employs fewer than 10 debt traders; provided, however, that with respect to paragraph (b)(2)(H)(ii) and (iii) of this Rule, such members must establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to paragraphs (b)(2)(A)(ii) and (iii), (b)(2)(B), (b)(2)(C), (b)(2)(D)(ii) and (iii), (b)(2)(E), (b)(2)(G) and (b)(2)(H)(ii) and (iii) of this Rule.

(j) Exemption for Debt Research Reports Provided to Institutional Investors

(1) Except as provided in paragraph (j)(2) of this Rule, the provisions of this Rule shall not apply to the distribution of a debt research report to:

(A) A qualified institutional buyer where, pursuant to Rule 2111(b):

(i) the member or associated person has a reasonable basis to believe that the qualified institutional buyer 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; and

(ii) such qualified institutional buyer has affirmatively indicated that it is exercising independent judgment in evaluating the member's recommendations pursuant to Rule 2111 and such affirmation covers transactions in debt securities; so long as the member has provided written disclosure to the qualified institutional buyer that the member may provide debt research reports that are intended for institutional investors and that are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors. If the qualified institutional buyer does not contact the member to request that such institutional debt research not be provided, the member may reasonably conclude that the qualified institutional buyer has consented to receiving debt institutional research reports; or

(B) a person that meets the definition of "institutional account" in Rule 4512(c); provided that such person, prior to receipt of a debt research report, has affirmatively notified the member in writing that it wishes to receive institutional debt research and forego treatment as a retail investor for the purposes of this Rule.

(2) Notwithstanding paragraph (j)(1) of this Rule, a member must establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest described in paragraphs (b)(2)(A)(i), (b)(2)(H) (with respect to pressuring), (b)(2)(I), (b)(2)(K), (b)(2)(L), (b)(2)(M), (b)(2)(N) and Supplementary Material .02(a) of this Rule.

(3) Debt research reports provided to institutional investors pursuant to this

exemption (“institutional debt research”) must disclose prominently on the first page that:

(A) “This document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors.”

(B) If applicable, “The views expressed in this report may differ from the views offered in [Firm’s] debt research reports prepared for retail investors.”

(C) If applicable, “This report may not be independent of [Firm’s] proprietary interests. [Firm] trades the securities covered in this report for its own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to the recommendation(s) offered in this report.”

(4) A member must establish, maintain and enforce written policies and procedures reasonably designed to ensure that institutional debt research is made available only to eligible institutional investors. A member may not rely on this exemption with respect to a debt research report that the member has reason to believe will be redistributed to a retail investor.

(5) This paragraph (j) does not relieve a member of its obligations to comply with the antifraud provisions of the federal securities laws and FINRA rules.

(k) Exemption for Good Cause

Pursuant to the Rule 9600 Series, FINRA may in exceptional and unusual circumstances, conditionally or unconditionally grant an exemption from any requirement of this Rule for good cause shown after taking into account all relevant factors, to the extent such exemption is consistent with the purposes of the Rule, the protection of investors, and the public interest.

• • • Supplementary Material: --------------

.01 Efforts to Solicit Investment Banking Business. FINRA interprets paragraph (b)(2)(L)(i) of this Rule to prohibit in pitch materials any information about a member's debt research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable debt research coverage. For example, FINRA would consider the publication in a pitch book or related materials of an analyst's industry ranking to imply the potential outcome of future research because of the manner in which such rankings are compiled. On the other hand, a member would be permitted to include in the pitch materials the fact of coverage and the name of the debt research analyst because such information alone does not imply favorable coverage. Members must consider whether the facts and circumstances of any solicitation or engagement would warrant disclosure under Section 17(b) of the Securities Act.

.02 Restrictions on Communications with Customers and Internal Personnel.

(a) Consistent with the requirements of paragraph (b)(2)(M) of this Rule, no debt research analyst may engage in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction.

(b) FINRA interprets paragraph (b)(1)(C) of this Rule to, among other things, require that any written or oral communication by a debt research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

.03 Information Barriers between Research Analysts and Trading Desk Personnel.

(a) FINRA interprets paragraph (b)(1)(C) of this Rule to, among other things, require members to establish, maintain and enforce written policies and procedures reasonably designed to prohibit:

(1) Sales and trading and principal trading personnel attempting to influence a debt research analyst's opinion or views for the purpose of benefiting the trading position of the firm, a customer or a class of customers; and

(2) Debt research analysts identifying or recommending specific potential trading transactions to sales and trading or principal trading personnel that are inconsistent with such debt research analyst’s currently published debt research reports, or disclosing the timing of, or material investment conclusions in, a pending debt research report.

(b) The following communications between debt research analysts and sales and trading or principal trading personnel are permitted:

(1) Sales and trading and principal trading personnel may communicate customers’ interests to a debt research analyst, so long as the debt research analyst does not respond by publishing debt research for the purpose of benefiting the trading position of the firm, a customer or a class of customers;

(2) Debt research analysts may provide customized analysis, recommendations or trade ideas to sales and trading and principal trading personnel

and customers, provided that any such communications are not inconsistent with the analyst's currently published or pending debt research, and that any subsequently published debt research is not for the purpose of benefiting the trading position of the firm, a customer or a class of customers;

(3) Sales and trading and principal trading personnel may seek the views of debt research analysts regarding the creditworthiness of the issuer of a debt security and other information regarding an issuer of a debt security 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 research analyst's published debt research report and consistent in nature with the types of communications that a debt research analyst might have with customers. In determining what is consistent with the debt research analyst's published debt research, a member may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the debt research analyst's published views; and

(4) Debt research analysts may seek information from sales and trading and principal trading personnel regarding a particular bond instrument, current prices, spreads, liquidity and similar market information relevant to the debt research analyst's valuation of a particular debt security.

(c) Communications between debt research analysts and sales and trading or principal trading personnel that are not related to sales and trading, principal trading or debt research activities may take place without restriction, unless otherwise prohibited.

.04 Disclosure of Compensation Received by Affiliates. A member may satisfy the disclosure requirement in paragraph (c)(4)(D) of this Rule with respect to receipt of non-investment banking services compensation by an affiliate by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the affiliate as to whether the affiliate received such compensation. In addition, a member may satisfy the disclosure requirement in paragraph (c)(4)(C) of this Rule with respect to the receipt of investment banking compensation from a foreign sovereign by a non-U.S. affiliate of the member by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the non-U.S. affiliate as to whether such non-U.S. affiliate received or expects to receive such compensation from the foreign sovereign. However, a member must disclose compensation received by its affiliates from the subject company (including any foreign sovereign) in the past 12 months when the debt research analyst or an associated person with the ability to influence the content of a debt research report has actual knowledge that an affiliate received such compensation during that time period.

.05 Submission of Sections of a Draft Research Report for Factual Review. Consistent with the requirements of paragraphs (b)(2)(B) and (N) of this Rule, sections of a draft debt research report may be provided to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or to the subject company for factual review, if:

(a) the sections of the draft debt research report submitted do not contain the research summary, recommendation or rating;

(b) a complete draft of the debt research report is provided to legal or compliance personnel before sections of the report are submitted to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company; and

(c) if, after submitting sections of the draft debt research report to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company, the research department intends to change the proposed rating or recommendation, it must first provide written justification to, and receive written authorization from, legal or compliance personnel for the change. The member must retain copies of any draft and the final version of such debt research report for three years after publication.

.06 Distribution of Member Research Products. With respect to paragraph (f) of this Rule, a member may provide different debt research products and services to different classes of customers. For example, a member may offer one debt research product for those with a long-term investment horizon ("investor research") and a different debt research product for those customers with a short-term investment horizon ("trading research"). These products may lead to different recommendations or ratings, provided that each is consistent with the meaning of the member's ratings system for each respective product. However, a member may not differentiate a debt research product based on the timing of receipt of a recommendation, rating or other potentially market moving information, nor may a member label a debt research product with substantially the same content as a different debt research product as a means to allow certain customers to trade in advance of other customers. In addition, a member that provides different debt research products and services for different customers must inform its other customers that receive a research product that its alternative debt research products and services may reach different conclusions or recommendations that could impact the price of the debt security. Thus, for example, a member that offers trading research must inform its investment research customers that its trading research product may contain different recommendations or ratings that could result in short-term price movements contrary to the recommendation in its investment research.

.07 Ability to Influence the Content of a Research Report. For the purposes of this Rule, an associated person with the ability to influence the content of a debt research report is an associated person who, in the ordinary course of that person's duties, has the authority to review the debt research report and change that debt research report prior to publication or distribution.

.08 Obligations of Persons Associated with a Member. Consistent with Rule 0140, persons associated with a member must comply with such member's written policies and procedures as established pursuant to this Rule. Failure of an associated person to comply with such written policies and procedures shall constitute a violation of this Rule. In addition, consistent with Rule 0140, it shall be a violation of this Rule for an associated person to engage in the restricted or prohibited conduct to be addressed through the establishment, maintenance and enforcement of written policies and procedures required by this Rule or related Supplementary Material.

.09 Joint Due Diligence. FINRA interprets paragraph (b)(1)(C) to prohibit the performance of joint due diligence (i.e., confirming the adequacy of disclosure in offering or other disclosure documents for a transaction) by the debt research analyst in the presence of investment banking department personnel prior to the selection by the issuer of the underwriters for the investment banking services transaction.

.10 Divesting Research Analyst Holdings. With respect to paragraph (b)(2)(J)(ii), FINRA shall not consider a research analyst account to have traded in a manner inconsistent with a research analyst's recommendation where a member has instituted a policy that prohibits any research analyst from holding securities, or options on or derivatives of such securities, of the companies in the research analyst's coverage universe; provided that the member establishes a reasonable plan to liquidate such holdings consistent with the principles in paragraph (b)(2)(J)(i) and such plan is approved by the member's legal or compliance department.

.11 Distribution of Institutional Debt Research During Transition Period. A member may distribute institutional debt research to any person that meets the definition of "institutional account" in Rule 4512(c), other than a natural person, for a period of up to one-year after [insert date of approval of the proposed rule change by the Securities and Exchange Commission] ("the transition period"). After the transition period, a member must have obtained the necessary consent in either paragraph (j)(1)(A) or (j)(1)(B) to distribute institutional debt research to a person. Natural persons that qualify as an institutional account under Rule 4512(c) must provide affirmative written consent to receive institutional debt research during the year transition period and thereafter. This Supplementary Material .11 shall automatically sunset at the end of the transition period.

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9600. PROCEDURES FOR EXEMPTIONS

9610. Application

(a) Where to File

A member seeking exemptive relief as permitted under NASD Rules 1021, 1050, 1070, 2340, or 3150, or Rules 2114, 2210, 2242, 2310, 2359, 2360, 3170, 4210, 4311, 4320, 4360, 5110, 5121, 5122, 5123, 5130, 6183, 6625, 6731, 7470, 8211, 8213, 11870, or 11900, or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of FINRA.

(b) through (c) No Change.

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