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FINRA
Notice to Members

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November 14, 2008

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006

Re: FINRA Regulatory Notice 08-55

Dear Ms. Asquith:

The Financial Services Group of Dechert LLP is pleased to have the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") proposal to adopt FINRA Rule 2240 (the "Rule"¹) relating to research analysts' conflicts of interest (the "Rule Proposal").² Specifically, we are concerned that the portion of the Rule Proposal which amends the definition of "research report" to exclude sales literature relating to open-end registered investment companies that are not listed or traded on an exchange or public direct participating programs ("DPPs") is too narrow. We agree that this exclusion is consistent with the definition of research report added to the Securities Exchange Act of 1934 (the "Exchange Act") by Section 501 of the Sarbanes-Oxley Act of 2002 ("SOX"). However, consistent with Section 501 of SOX, the exclusion should also encompass sales literature relating to hedge funds and private equity funds (collectively, "private funds") so that no public or private fund sales literature would be subject to the requirements of the Rule.³

¹ Proposed FINRA Rule 2240 amends and replaces NASD Rule 2711. Unless otherwise indicated herein, all references to the Rule includes NASD Rule 2711.

² Financial Industry Regulatory Authority, Regulatory Notice 08-55, *Research Analysts and Research Reports* (Oct. 2008).

³ We note that other organizations have advanced similar, and in some cases identical, conclusions with regards to other types of investment products in connection with SR-NASD-2006-113, an earlier NASD rule filing that included the proposed change to Rule 2711. *See, e.g.*, Letter from Michael D. Udoff, Securities Industry and Financial Markets Association, to the U.S. Securities and Exchange Commission, dated March 5, 2007 (noting that sales materials related to exchange traded funds ("ETFs") and private funds should also be excluded from the definition of research report); Letter from Donald S. Weiss, Bell, Boyd & Lloyd LLP, to the U.S. Securities and Exchange Commission, dated March 1, 2007 (noting that sales materials related to private funds should also be excluded from the definition of research report); Letter from Jack Hollander, Investment Program Association, to the U.S. Securities and Exchange Commission, dated March 5, 2007 (noting that sales materials related to non-traded real estate investment trusts should also be excluded from the definition of research report); Letter from David A. Hebner, Wachovia Securities, LLC, to the U.S. Securities and Exchange Commission, dated February 28, 2007

Dechert is an international law firm serving clients in the United States and worldwide. The Financial Services Group of Dechert provides advice and assistance to a wide variety of U.S. and non-U.S. investment companies and private funds, as well as investment advisers, fund administrators, broker-dealers, insurance companies, commercial banks, and thrift institutions. An extensive part of our services for these clients involves assistance in compliance with federal and state securities laws in the organization, distribution, and operation of investment funds, including those registered with the Commission and those not subject to registration. The comments that follow reflect our own views and not necessarily those of any client of the firm.

As we explain in detail below, and based on the rationale previously advanced by FINRA,⁴ sales literature relating to private funds, the attributes of which are similar to those of sales literature relating to open-end registered investment companies and public DPPs, should also be excluded from the definition of “research report.” Additionally, the public policy concerns that prompted the adoption of the conflict of interest rules for research analysts – and the concerns that justify regulating “research reports” – are not present in the context of sales literature relating to private funds.

I. Background

The Rule’s definition of “research report,” which was adopted in whole from Section 15D(c)(2) of the Exchange Act, is a “written (including electronic) communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision.”⁵ Section 15D, added to the Exchange Act by SOX Section 501, mandated the adoption of rules to “address conflicts of interest that can arise when securities analysts recommend equity securities in research reports . . . in order to improve the objectivity of research and provide investors with more useful and reliable information.”

The breadth of the definition of “research report” has created significant uncertainty about the scope and application of the Rule, including its application to mutual fund sales literature. The *Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules*, published in December 2005 (the “Joint Report”), noted the very broad definition of “research report,” and recommended codifying certain interpretations of the definition so that the Rule would not apply to sales literature relating to “registered investment companies.” (The Joint Report did not include the qualifier “open-end” to registered investment companies, which is in the Rule Proposal.) The Rule Proposal, among other things, amends the definition of “research report” to exclude sales literature relating to open-end registered investment companies that are not listed or traded on an exchange or public DPPs.

(noting that sales materials related to ETFs, closed-end funds and hedge funds should also be excluded from the definition of research report).

⁴ See *Self-Regulatory Organizations; New York Stock Exchange LLC and the National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Changes to Amend NYSE Rules 472 and 344, and NASD Rules 1050 and 2711 Relating to Research Analyst Conflicts of Interest*, Securities and Exchange Commission (“SEC”), Release No. 34-55072, SR-NASD-2006-113 (Jan. 9, 2007) (the “2006 Rule Proposal”).

⁵ NASD Rule 2711(a)(9).

In connection with the distribution of private funds, registered broker-dealers produce sales literature that is directed to accredited investors interested in private funds and that contains information, such as performance information, about private funds, which a fair reading would lead one to believe may be "sufficient upon which to base an investment decision," i.e., a "research report." After the Joint Report was published, FINRA staff verbally reiterated to us their belief that the Rule applies to private fund sales literature. Accordingly, and consistently with the observation of the Joint Report, we have assumed that it is FINRA's view that the Rule applies to private fund sales literature.

II. The Proposed Exclusion Should Be Expanded Consistent With the Apparent Purpose of the Definition of Research Report and to Eliminate Confusion

We urge FINRA to expand the proposed exclusion so that the Rule will not apply to private fund sales literature because the risks that the Rule is intended to address are absent with respect to sales literature relating to securities that are not traded in secondary markets or that are redeemable by the issuer. Instead, the proposed exclusion should be expanded so that the definition of "research report" is limited to communications: (i) relating to equity securities that are traded in public secondary markets, (ii) relating to equity securities that are not redeemable at the option of the investor, and (iii) published by a person who is not the distributor or agent of the issuer.

Section 15D and the Rule were not intended to address communications that are clearly presented as sales literature and that are governed by the rules and standards applicable to sales literature. While sales literature is expected to be "fair and balanced,"⁶ there should be no expectation that it is objective analysis. Accordingly, we believe the Rule Proposal should be amended to ensure that sales literature relating to private funds is not subject to the requirements of the Rule. Moreover, sales literature that is clearly marketing material and not objective analysis should not be subjected to the additional regulatory regime designed to preserve the objectivity of research.

Subjecting broker-dealers distributing private funds, as well as foreign funds sold in private placements in the United States and other types of equity alternative collective investment products, to the Rule's requirements is unnecessary because, as discussed in IV.A, below, private fund distribution practices were not the reason behind adopting the Rule. Imposing the requirements of the Rule on private fund distributors will affect the use of offering summaries, pitch books, power-point presentations, term sheets and other commonly used forms of sales literature that are not prospectuses or offering memoranda.⁷

⁶ See NASD Rule 2210(d)(1).

⁷ NASD, SR-NASD-2006-112, *Proposed Rule Change to Amend NASD Rule 2711 to Codify Existing Interpretive Guidance Relating to Research Analyst Rules*, filed for immediate effectiveness on Sept. 27, 2006 and published at 72 F.R. 62331 (Oct. 24, 2006), codified an interpretation that excludes "periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual securities in the context of a fund's or an account's past performance or the basis for previously made discretionary investment decisions" from the definition of "research report." This change clearly permits performance information in prospectuses and offering memoranda, while the Rule Proposal's exclusion is more limited and would prohibit the use of performance information in private fund sales literature that is not a prospectus or offering memorandum.

As noted above, FINRA apparently takes the position that the Rule applies to all types of sales literature that meet the definition of research report, whether such sales literature relates to private funds, public closed-end funds, ETFs and other equity alternative investment products. In our experience we have found that private fund distributors are generally unaware that FINRA takes this counterintuitive and surprising view.⁸ Moreover, the fact that few are aware of FINRA view of the Rule's scope indicates confusion over the scope and application of the Rule with regard to private fund sales literature. This lack of awareness and confusion may also indicate that the effect of the Rule and its costs and benefits were not fully understood nor adequately considered at the time the Rule was adopted.⁹

III. FINRA's Rationale for Exempting Open-End Registered Investment Companies and Public DPPs From the Rule Applies Equally to Private Funds

Although not addressed in detail in the Rule Proposal, the 2006 Rule Proposal justified excluding from the definition of "research report" sales literature of open-end registered investment companies because such sales literature is subject to a separate regulatory regime, including FINRA Rule 2210 and SEC Rule 482, both of which set the content standards for sales literature.¹⁰ FINRA also noted that registered fund sales literature is subject to filing with FINRA within ten days of its first use, but does not explain how the filing requirement justifies limiting the exclusion to open-end registered investment companies. We urge FINRA to consider that the filing requirement applicable to registered fund sales literature is a procedural requirement designed to assure that widely distributed registered fund sales literature is subject to orderly review, while private fund sales literature, because of its more sophisticated audience and limited non-public distribution, need not be subject to intensive review. Accordingly, the justification for the distinction FINRA draws between registered fund sales literature and private fund sales literature – that registered fund sales literature is subject to FINRA review – should not be considered a substantive protection that supports limiting the proposed exclusion to registered fund sales literature. The content requirements of FINRA Rule 2210 are equally applicable to both registered and private fund sales literature. Moreover, the Rule 482 requirements applicable to registered fund sales literature arise because of the need to reconcile such sales literature with the prospectus requirements of the Securities Act of 1933 ("Securities Act").

FINRA also proposed to exclude public DPP sales literature because it is subject to FINRA Rule 2210, including the requirement that it must be filed with FINRA within ten business days of its first use. The 2006 Rule Proposal noted that the sales literature of DPPs generally consists of "tombstone" advertisements and, therefore, is also subject to SEC Rule 134. FINRA asserted that public DPPs

⁸ A review of the relevant literature has not identified any instance in which FINRA has publicly stated its expectation that the Rule would apply to private fund sales literature, nor are we aware of any instance where FINRA has sought to enforce the Rule against publishers of such sales literature. Nevertheless, the effect of comment letters such as the ones cited in footnote 3, above have highlighted for the first time the fact that industry participants believe there is ambiguity which FINRA should resolve.

⁹ We note that the definition of "Research Report" in the Rule is the same as the definition in SEC Regulation AC.

¹⁰ See 2006 Rule Proposal, *supra*, note 4. Because the Rule Proposal does not address the proposed definition of "research report," we will address the reasoning offered by the 2006 Rule Proposal, which attempted to amend the definition of "research report" in the same manner as the Rule Proposal.

typically are not traded on an exchange and do not have an active secondary market.¹¹ FINRA did not cite any source for this assertion. Public DPPs are sometimes exchange listed or traded in the secondary market because they are registered. In fact, it is precisely these characteristics that appear to make public DPPs more akin to individual operating company equity securities. Unregistered funds that are organized as DPPs or limited liability companies, by contrast, generally do not trade in secondary markets because of their structural characteristics such as redemption restrictions and resale prohibitions.

FINRA Rule 2210 regulates the content of private fund sales literature¹² and requires sales literature to be based on “principals of fair dealing and good faith.” Sales literature must be fair and balanced and must not omit any material facts if the omission, in light of the context, would cause the communication to be misleading.¹³ In addition, Rule 2210 prohibits members from making any false, exaggerated, unwarranted or misleading claim in communications with the public, and communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated claim, opinion or forecast. Rule 2210 also specifies that sales literature must disclose the relationship between the registered broker-dealer and the non-member or individual who is named. Finally, even if a non-member private manager prepares the sales literature, the sales literature is subject to the content requirements of Rule 2210 if a member uses it to sell a private fund.¹⁴

Although private fund sales literature is not subject to post-use review by FINRA, such review is not necessary.¹⁵ Unlike open-end registered investment companies and public DPPs, the distribution of private fund sales literature is limited to sophisticated investors.¹⁶ These investors are considered more

¹¹ See *id.* at 11.

¹² The NASD and others have interpreted Rule 2210 to apply equally to the sales literature of registered funds and private funds. See NASD, Interpretative Letter, *Further Interpretative Advice to Members Concerning the Sale of Hedge Funds* (Oct. 2, 2003) [hereinafter SIA Letter]; see also NASD, Interpretive Letter, *Guidance Regarding Use of Related Performance Information in Sales Material for Private Equity Funds* (Dec. 30, 2003) [hereinafter Davis Polk Letter].

¹³ See NASD, IM-2210-1, *Guidelines to Ensure That Communications With the Public Are Not Misleading*; see also NASD, Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds* (Feb. 2003).

¹⁴ See SIA Letter, *supra* note 12.

¹⁵ The 2006 Rule Proposal noted that the “NASD Advertising Regulation Department review of registered investment company and public DPP sales literature reduces the likelihood that it will contain content that is not fair and balanced.” 2006 Rule Proposal, *supra* note 4; see also Davis Polk Letter, *supra* note 12; SIA Letter, *supra* note 12.

¹⁶ Sophisticated investors are investors that are “qualified institutional buyers,” as defined by Rule 144A under the Securities Act, “qualified purchasers,” as defined by Section 2(a)(51) of the Investment Company Act of 1940 (“Investment Company Act”), or “accredited investors,” as defined by Rule 501(a) under the Securities Act.

Though the SEC is proposing to revise the definition of “accredited investors,” as it applies to natural persons, the SEC is not proposing to change the principle that select investors do not need as much regulatory protection as the public. SEC, Release 33-8766, *Prohibition of Fraud by Adverse to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles* (Dec. 27, 2006) (proposing new standards to limit the number of investors that qualify as accredited investors because overall personal wealth has increased, as a result of inflation and increased personal residence values, so

capable of objectively evaluating sales literature and, therefore, the concerns related to the widespread public dissemination of research are not present. In fact, FINRA, in an interpretive letter concerning a particular class of private funds, noted that, with respect to related performance in sales literature, private funds do not present the same investor protection concerns compared to mutual funds.¹⁷ Private funds also are generally not subject to the registration requirements of the Investment Company Act and Securities Act because their shares are sold to sophisticated investors in limited offerings.¹⁸ Because sales literature for private funds is subject to the same content standards as apply to open-end registered investment companies and public DPPs, FINRA's justifications for the scope of the proposed exclusion should apply equally to private fund sales literature. Finally, any performance information in private fund sales literature must meet the same Rule 2210 requirements that apply to registered investment companies.¹⁹ Accordingly, we urge FINRA to consider that, because Rule 2210 sets content standards for advertising and sales literature, it should not impose additional regulatory burdens on private fund sales literature by declining to extend the proposed exclusion.

IV. Regulatory Concerns Justifying the Regulation of Research Reports Do Not Apply in the Context of Private Fund Sales Literature

A. Private Funds Are Priced at Net Asset Value, Not by the Market

The conflicts of interest that FINRA sought to address when enacting Rule 2711 are not a regulatory concern for private funds. FINRA adopted the Rule to address the influence that investment bankers exerted on research analysts to speak favorably about specific companies or issuers.²⁰ FINRA noted that "[t]he 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."²¹ FINRA was concerned with research analysts having a financial interest in the issuers that they covered and, as a

that the percentage of U.S. households that qualify for accredited investor status has increased from 1.87% to 8.47% between 1982 and 2003, while investment products have increased in complexity).

¹⁷ Davis Polk Letter, *supra* note 12.

¹⁸ *See id.*

¹⁹ *See id.*

²⁰ The NASD sought to address the circumstances that compromised the objectivity of research by research analysts "and 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." *Id.* at 2.

²¹ Joint Report, *supra* at 2 ("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.'"). Congress expressed similar concerns when addressing research analysts' conflicts of interest. *See* S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT OF 2002, S. Rep. No. 107-205, at 41 (2002) ("The Committee [on Banking, Housing and Urban Affairs] heard persuasive testimony that a serious problem exists regarding conflicts of interest between Wall Street stock analysts and their employing brokerage firms, on the one hand, and the public companies that the stock analysts cover, on the other hand. Growing knowledge of these conflicts is harming the integrity and creditability to the public of stock analyst recommendations.") (emphasis added).

result, attempting to manipulate the price of securities traded on an exchange through the issuance of unduly favorable research reports.²²

By contrast, it is impossible to manipulate the price of a private fund. A private fund's value is calculated in the same manner as the value of an open-end registered investment company—using the fund's net asset value ("NAV"). Because private fund sales literature cannot affect the NAV of a private fund, subjecting such sales literature to regulation under a rule that was designed to prevent price manipulation is unnecessary, burdensome, and contrary to legislative intent.

B. Private Fund Sales Literature Does Not Contain Analysis

Private fund sales literature is more similar to open-end registered investment company sales literature than to single operating company equity security research reports. A "research report" has (i) "information reasonably sufficient upon which to base an investment decision" and (ii) "analysis" about securities of "individual companies." Although investors may use private fund sales literature to decide whether to purchase or sell a fund, private fund sales literature does not generally contain the type of analysis that is included in research reports for operating companies. Nor is the type of analysis performed on operating companies applicable to the private funds. The two main types of analysis that are in research reports for operating companies are technical analysis²³ and fundamental analysis. Technical analysis refers to:

research into the demand and supply for securities, options, mutual funds and commodities based on trading volume and price studies. Technical analysts use charts or computer programs to identify and project price trends in a market, security, fund or futures contract. Most analysis is done for short- or intermediate-term, but some technicians also predict long-term cycles based on charts and other data.²⁴

Fundamental analysis is the:

analysis of the balance sheet and income statements of companies in order to forecast their future stock price movements. Fundamental analysts consider past records of assets, earnings, sales, products, management and markets in predicting future trends in these indicators of a company's success or failure. By appraising a firm's prospects, these analysts assess whether a particular stock or group of stocks is undervalued or overvalued at the current market price.²⁵

²² Conflicts included basing analysts' compensation on their contributions in support of investment banking transactions and the profitability of the investment banking unit, as well as analysts covering companies underwritten by the analysts' firms; investing in pre-initial public offerings of companies that they initially covered and for which their firms had acted as underwriters; and issuing favorable research reports or "buy" recommendations close to the expiration of a lock-up period. *Id.*

²³ FINRA asserted that, in the discussion of the definition of "research report" under the research analyst rules, it would not exclude technical or quantitative analysis from the definition of research report. *See* NASD Notice to Members 04-18, *Research Analysts and Research Reports* (March 2004)

²⁴ Dictionary of Finance and Investment Terms, 548-49 (4th ed. 1995).

²⁵ *Id.* at 211.

Technical analysis is not applicable to a registered fund or private fund. Demand and supply, the basis of technical analysis for operating companies, do not influence the price of a registered fund or private fund, because, as noted earlier, a fund's price is based on the net value of its underlying portfolio securities. For example, the newsletters that broker-dealers produce include information about economic and market developments, but such information is general and is not about the underlying portfolio securities of the funds in which the investor is investing.

Similarly, with regard to fundamental analysis, analyzing assets, earnings, sales, products, management and markets in order to identify trends in a private fund would be meaningless because, in some cases, there is no such information, and, in other cases, only the information that relates to the underlying portfolio securities is meaningful. This information would not be about the private fund in which the investor is investing.

Finally, analysis in any of its forms involves the separate examination of constituent parts of an "individual company" engaged in commercial or industrial enterprises to form conclusions as a consequence of reasoning.²⁶ Unlike a single operating company equity security, which may be separated into its constituent parts (*e.g.*, price and market data, financial statement information, etc.),²⁷ a private fund is not composed of the same constituent parts of an operating company. Any analysis of a private fund would be problematic because a particular portfolio's securities are both concealed and ever changing.

FINRA should recognize that sales literature, regardless of whether the subject matter is a registered fund or private fund, is not a research report within the context of the Rule because it does not contain the technical or fundamental components of analysis. In addition, information about private funds does not contain information about individual companies that produce a product or provide a service.

Finally, private fund sales literature is likely to include information about the characteristics of the product and an assessment of its manager. Typically, this may be a restatement of information provided in fund offering documents (such as management style and tax consequences) coupled with personal evaluations. This type of discussion in the context of registered funds is not analysis²⁸ and, accordingly, should not be considered analysis in the context of private funds.

IV. Conclusion

For the foregoing reasons we urge FINRA to extend the Rule Proposal to exclude from the definition of "research reports" the sales literature of private funds because the risks that the Rule is intended to address are not present with respect to sales literature relating to securities that are not traded in secondary markets or that are redeemable by the issuer. Sales literature that is clearly marketing material and not objective analysis should not be subjected to the additional regulatory regime designed to preserve the objectivity of analysis. FINRA's previously articulated rationale for excluding from the definition of "research reports" the sales literature of open-end registered investment companies and public DPPs (*i.e.*, that Rule 2210 regulates such sales literature) applies equally to private funds. Finally, the regulatory concern that private fund sales literature will manipulate the value of a private fund is not

²⁶ See Webster's II New Riverside University Dictionary, 104 (1984).

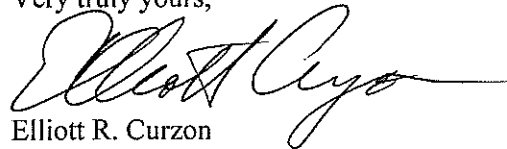
²⁷ See Black's Law Dictionary (5th ed. 1979).

²⁸ FINRA staff, in discussions about interpreting the Rule, made this observation.

an issue because private funds are priced at NAV, not by the market. In addition, private fund sales literature does not contain the type of analysis that research analysts manipulated, and this manipulation is what led to the adoption of Rule 2711.

We appreciate the opportunity to comment on this Rule Proposal. If you have any questions concerning the foregoing, please contact me. Thank you for your attention to this matter.

Very truly yours,



Elliott R. Curzon

cc: James A. Brigagliano
Associate Director SEC Division of Trading and Markets

Marc Menchel
FINRA Regulatory Policy and Oversight's Office of General Counsel