

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 Institute¹ 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.

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

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.

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
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/s/ Linda L. Rittenhouse

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