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.

[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. Compatibility with Other Regulatory Requirements – CFTC Rules

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

[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. ADDITIONAL COMMENTS – ROAD SHOW PROHIBITION

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.

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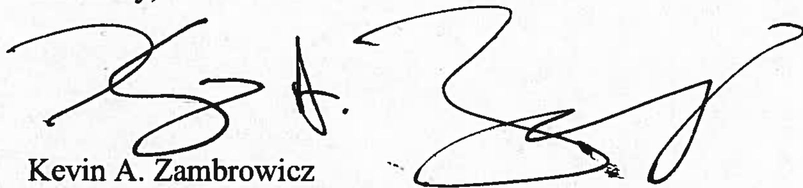
SIFMA appreciates the opportunity to comment on the Proposed Rule. SIFMA reiterates our support for many of the proposed provisions, subject to the concerns outlined above. SIFMA would be pleased to discuss any of these points further, and to provide additional information you believe would be helpful. 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