

9 February 2015

Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: Self-Regulatory Organizations: Financial Industry Regulatory Authority, Inc.: Notice of Filing of a Proposed Rule Change to Adopt FINRA's Rule 2242 (Debt Research Analysts and Debt Research Reports) (Release No. 34-73623; File No. SR-FINRA-2014-048)**

Dear Mr. Fields:

CFA Institute<sup>1</sup> appreciates the opportunity to provide the Securities and Exchange Commission (SEC) our comments on FINRA's proposed rule to address 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.

CFA Institute has long supported efforts to create meaningful ways to ensure the independence and objectivity of analyst research reports. In 2002, we published Research Objectivity Standards (Standards) (see <http://www.cfainstitute.org/ethics/codes/research/Pages/index.aspx>) aimed at providing standards, guidance and recommended practices for use by corporate issuers, institutional investors, the media, and investment bankers and broker-dealers. Among other things, the Standards focus on the disclosure of potential and actual conflicts of interest and the creation of policies and procedures to minimize and manage conflicts of interest that may jeopardize the independence and objectivity of research.

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<sup>1</sup>CFA Institute is a global, not-for-profit professional association of more than 128,300 investment analysts, advisers, portfolio managers, and other investment professionals in 147 countries, of more than 121,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 144 member societies in 69 countries and territories.

## Executive Summary

CFA Institute supports efforts aimed at preventing conflicts of interest relating to the work of research analysts in the investment banking and trading sides of brokerage firms, as well as in other types of research, rating and investment firms. Untainted research must be safeguarded from undue influence that otherwise erodes market integrity and investors' trust in the system. While exchange rules have largely regulated equity research analysts at sell-side firms for more than a decade, debt research analysts have operated under different rules that often overlook potential conflicts of interests for such analysts. We note that members of our organization are obligated to operate under strict requirements for addressing conflicts and independence, regardless of the type or firm or security involved. That said, we agree with FINRA that implementing the proposed regulation will help close a regulatory gap and provide more consistency.

We generally agree with FINRA's proposed approach to regulating this area and strongly support its intent to offer investors untainted research and otherwise protect the integrity of information being provided investors. We also appreciate that the approaches taken in this proposal with respect to debt research closely track the existing requirements for equity research reports. Moreover, we encourage a close look at and reference to the CFA Institute Standards of Professional Conduct as another source for best practices in this regard.

***Permissible Communications by Debt Research Analysts.*** We generally support the proposed areas of communications in which debt research analysts may engage. Tracking substantially those requirements applicable to equity research analysts, we believe that these areas are reasonable and are sufficiently tailored to reflect particular characteristics of the debt securities market.

***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.

***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. We also encourage FINRA to provide specific guidance on what measures would qualify to protect analysts at smaller firms from pressure from personnel in other departments, should the exemption be approved.

***Limited Investment Banking Exemption.*** We recognize the proposed exemption for firms with limited investment banking activities generally harmonizes with what FINRA rules currently provide for equity security research. We have the same concern, however, that should this

exemption be implemented, analysts may not be sufficiently insulated from internal pressures, and we therefore urge specific guidance on this point.

While we appreciate the rationale for proposing exemptions for firms with limited principal debt trading and investment banking activities, we remain concerned that conflicts and pressures on independence can corrupt research provided by firms that would fall under the exemptions. Ensuring that investors do not receive or rely on tainted research must remain a priority when constructing these rules. We therefore urge a careful review and analysis of these two proposed exemptions with an eye to whether the costs to the firms outweigh the potential benefits to the markets in safeguarding the integrity of debt research reports.

### **Discussion**

As a membership organization of Chartered Financial Analysts, we are keenly aware of, and strongly support, efforts to manage conflicts of interest in 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 to business opportunities or to otherwise have their compensation linked to activities outside those related to the quality and demand for such research. As importantly, the marketplace must be able to trust the impartiality of the analysts and the integrity of the reports they write if they are 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 arms of firms and their investment banking businesses. 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 continue to support FINRA's rules to enhance 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 further 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. Under proposed FINRA Rule 2242, debt research analysts will now be subject to substantially the same rules as those currently applicable to equity research analysts, with certain exemptions relating to debt research provided to institutional investors. This approach will help to close several gaps. First, as noted in the Release, FINRA's current research analyst rules apply only to equity analysts; the SEC's Regulation Analyst Certification applies to both debt and equity analysts; and the Sarbanes-Oxley Act sets forth restrictions on equity research, but not for debt research. The proposed rule would help to address these discrepancies and provide rules for debt research analysts that track in large measure the spirit and scope of equity research regulation.

Proposed Rule 2242 departs from the requirements on equity research analysts in three notable aspects. First, it distinguishes between prohibited and permissible communications by debt research analysts with principal trading, sales, and trading personnel, in recognition of characteristics specific to the debt, such as limitations on price discovery and the need for interactions with trading personnel to perform credit risk analysis on inventory. Second, debt research provided only to institutional investors would be exempt from certain requirements. Finally, those engaging in limited principal trading activity would also be exempt from requirements that apply to those not so limited.

### **Permissible Communications by Debt Research Analysts**

As an overarching principal, Rule 2242 requires FINRA members to implement policies and procedures that are “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.” These policies and procedures, among other areas, address the following:

- **Prepublication review:** The subject company is prohibited from prepublication review, except for verification of facts;
- **Coverage decisions:** Research management must make final decisions on research coverage plan, but personnel from investment banking, sales and trading and principal trading departments may convey customer interests and coverage needs;
- **Solicitation and marketing of investment banking transactions:** Analysts are prohibited from participating in pitches, road shows, marketing on behalf of issuers, and investment banking personnel are prohibited from directing analysts to participate in sales or marketing actions;
- **Supervision:** Information barriers must be implemented to ensure analysts aren't pressured by others in their firms;
- **Budget and compensation:** While the research budget must be set by senior management not involved in investment banking or principal trading activities, others may provide input on the demand for and quality of debt research, to enable senior management to consider a firm's overall revenues. While generally tracking the restrictions applicable to equity research, the proposed rule would extend the separation restrictions for debt research analysts affiliated not only with investment banking, but also to those engaged in principal trading activities. Sales and trading may provide limited input through customer feedback, but are not involved in final compensation determinations.
- **Personal trading restrictions:** Research analysts cannot trade securities, derivatives or funds in a manner contrary to their most recently published recommendations.

- **Retaliation and favorable research:** Policies and procedures must prohibit retaliation against analysts who make public appearances that affect a firm's business interests. Those same policies and procedures also must prohibit promises of favorable research or ratings as inducements for business or compensation.
- **Joint due diligence with investment banking personnel:** Analysts cannot conduct due diligence activities prior to selection of underwriters for investment banking mandates.
- **Communications between debt research analysts and trading personnel:** Personnel from sales and trading and principal trading cannot attempt to enhance their trading positions by influencing research analysts. Nevertheless, communications with analysts not related to sales and trading are allowed. For example, sales personnel can communicate customer interests to analysts as long as related research doesn't attempt to enhance the firm's trading positions, customers, or a class of customers. Analysts can only comment on the creditworthiness of an issuer to internal personnel if those views are consistent with published research. And analysts can seek information about prices, spreads and other relevant information from such personnel that will be used by the analyst in his or her valuation analysis.
- **Restrictions on communications with customers and internal sales personnel:** Debt research analysts may communicate with customers in the presence of investment banking or management personnel about investment banking services transactions.
- **Content and disclosure in debt research reports:** Rule 2242 requires policies and procedures to ensure that facts in research reports are based on reliable information, that recommendations have a reasonable basis, and that there is disclosure relating to "buy," "hold" or "sell" ratings. Firms would have to disclose a number of things about analyst holdings and compensation, affiliate activities and compensation, trading as principals, as well as other potential conflicts of interest. Unlike equity research rules, this rule would not require disclosure if the firm or affiliates own 1% or more of the securities of the subject company, in recognition that "firms do not typically have systems to track ownership of debt securities." Instead, firms would have to disclose firm ownership issues when they amount to material conflicts of interest.
- **Disclosure in public appearances:** Neither firms nor analysts would be required to disclose material non-public information that would reveal specific potential future investment banking transactions involving the subject company. The reason for this rule, which is contrary to rules relating to equity research, is that the "catch-all" requirement for public appearances for debt research analysts only extends to what they know or have reason to know at the time of their appearances.
- **Distribution of member research reports:** Firms may distribute different reports to different classes of customers, as long as they are not timed to provide market-moving information to certain groups ahead of others, and as long as the policies to distribute reports are disclosed to all. Firms providing different research products and services to different customers may

also reach different conclusions or recommendations that may affect the price of particular debt securities, as long as this is fully disclosed.

- Distribution of third-party debt research reports: The proposed rule also would require the disclosure of any material conflict of interest that is reasonably expected to have influenced the choice of a third-party research provider or the company that is the subject of the report.

In general, we believe this list of policies and procedures relating to communications between analysts and others relating to investment research are appropriate.

### **Exemption for Debt Research Reports Provided to Institutional Investors**

FINRA's proposed rule recognizes certain differences in how debt markets operate and how debt research is used relative to equity research. In particular, FINRA notes that because debt securities are often priced in relation to interest rate measures or benchmark securities rather than issuer fundamentals, debt research reports are not as likely to influence the price of a particular company's debt securities as equity research might. It also recognizes the different types of research conducted on debt securities market—on the creditworthiness of an issuer of particular securities; on debt asset classes or particular issues within class; on a macroeconomic level, without focus on particular securities and classes; and “trader commentary” (consisting of “market color, analysis, and trading ideas”) generated by trading desks and geared more toward institutional clients.

In recognizing these differences, Rule 2242 would adopt a “tiered” approach whereby debt research provided to retail clients generally would be subject to equity research requirements. At the same time, research provided only to institutional investors would be exempt from some of the disclosure requirements and other protections afforded retail investors. In offering this approach, FINRA hopes to continue to provide important investor protections to retail investors, while also recognizing the differences in equity and debt research markets and the use by sophisticated institutional investors, especially of the “market commentary” noted above.

Specifically, the proposed rule would exempt research that is provided to eligible institutional investors from most of the equity research rules regarding supervision, coverage determinations, and budget and compensation determinations. Such research would also be exempt from all of the disclosure requirements that apply to debt research reports provided to retail investors.

The proposal permits a tiered approach related to how institutional investors could receive the research reports. Larger institutional investors would receive 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 FINRA member or associated person has a reasonable basis to believe the investor is capable of evaluating the risks independently, and (b) the QIB confirms it is exercising independent judgment in evaluating the firm's recommendations.

Smaller institutional investors that do not qualify as QIBs may consent to receive such research reports by affirmatively consenting in writing. Retail investors may not, however, elect to receive debt research reports that are exempt from the disclosure and other requirements under any consent mechanism.

All research provided to institutional investors through the tiered approach would still be subject to requirements prohibiting prepublication review of opinions by investment banking personnel and by subject companies. Moreover, such research would also honor the prohibitions against analyst participation in the solicitation of investment banking services, road shows, and other marketing activities on behalf of issuers, as well as the rules forbidding retaliation against analysts. FINRA reasons in the proposal that regardless of the sophistication of the investors receiving research, certain standards should still apply aimed at ensuring objectivity. Finally, a firm distributing research reports to eligible institutional investors would need to provide disclosure that the reports are not subject to the same independence standards as those provided retail investors.

We generally support this approach. A QIB that qualifies under Rule 144A presumably has the human and financial resources, together with the sophistication to evaluate the research involving debt securities without the disclosures and other protections that accompany reports provided retail investors. We also support the proposed requirement that institutional investors who do not fall within the higher tier category still be allowed to receive the research without the retail investor protections if they notify the provider firm in writing of this election.

We do have concerns, however, about provisions in the proposal that would allow research provided to institutional investors to contain views that differ from views offered in retail debt research reports. While reports to institutional investors would provide disclosure of this, we believe the issue goes beyond one of disclosure. It raises issues about the parity of information received by retail and institutional investors, and whether one group of investors can receive advantaged information. We urge review of this aspect of the proposal.

### **Exemption for Limited Principal Trading Activity**

Proposed Rule 2242 provides certain exemptions for FINRA members who have limited principal trading activity and revenues stemming from debt trading. Specifically, it would exempt such firms from the requirement to separate research analysts from sales and trading and principal trading personnel and with regard to supervision and compensation of the research analysts.

This proposal tracks closely with existing FINRA equity security research rules by maintaining an exemption for firms that have limited investment banking activity. Under the proposed exemption, firms would not have to implement procedures that: (a) prohibit prepublication review of the research by principal trading or sales and trading personnel or others not directly responsible for the reports (the exemption would not extend to investment banking personnel unless another exemption is applicable); (b) limit supervision of the analysts to persons not

engaged in sales and trading or principal trading, including input into compensation or research budget determinations; (c) require compensation committees not to have principal trading representatives; and (d) create information barriers insulating the analysts from review or oversight by persons engaged in principal trading or sales and trading activities.

Firms would be required to implement information barriers or safeguards ensuring that debt research analysts are protected from pressure from staff engaged in such activities.

FINRA notes that in proposing this exemption, it considered the ability of smaller firms and its limited personnel to separate research and principal debt trading activities, as well as its belief that limited principal trading poses reduced pressures on debt analysts from sales and trading personnel. In order to qualify for the exemption, however, firms would be limited to: (1) average annual principal debt trading gains or losses (in absolute value) of no more than \$15 million over the previous three years; and (2) no more 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 indicated that firms with fewer than 10 debt traders typically do not dedicate a trader to writing research. FINRA has concluded that separation requirements would impose appreciable compliance burdens on such firms that would outweigh expected benefits to investor protections. The evidence with regard to the negative effects of conflicted interests 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 publication and distribution is an unacceptable outcome, regardless of the size of a firm's trading desk.

While we understand the rationale for FINRA's creation of the exemption in this case, we question whether the proposed solution of no separation is sufficient to ensure truly independent research. In general, therefore, we are not convinced that the potential for conflicts has been adequately addressed by the proposed rule. We, nevertheless, appreciate FINRA's commitment to monitor the research by firms claiming the exemption to evaluate whether these thresholds are correct or should be modified, and urge publication of these findings, in expectation that a solution that carefully weighs the burdens on small firms while ensuring the independence of investment research could be found.

We strongly encourage FINRA to provide additional guidance as to what specific measures should be taken 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." (Emphasis in original) Given the removal of the separation requirements, a statement, without specific and measureable requirements, that analysts should be insulated from pressure is not enough.



## **Limited Investment Banking Exemption**

Proposed Rule 2242 tracks existing FINRA equity security research rules by maintaining an exemption for firms that have limited investment banking activities. Under the exemption, firms would not have to separate research analysts from investment banking personnel with respect to (a) prepublications review of the research; (b) providing input into coverage decisions; (c) supervision and compensation of research analysts; and (d) research budget determinations. They would, however, have to establish “information barriers or other institutional safeguards” to insulate debt research analysts from pressure by those engaged in investment banking, principal trading or principal sales and trading activities.

Firms qualifying for the exemption would, during the previous three years (on average per year), have acted as manager or co-manager in 10 or fewer investment banking transactions and generated \$5 million or less in gross investment banking revenues from those transactions. Firms relying on this exemption would need to maintain records establishing their eligibility.

We have reservations about this exemption similar to those expressed with respect to the exemption for firms engaging in limited principal trading. 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, without more specific guidelines as to what barriers or safeguards must be implemented to insulate the analysts from pressure.

## **Conclusion**

We appreciate FINRA’s efforts to establish regulations for debt security research that are substantially consistent with those implemented for equity security research. Given the important safeguards in question, we encourage additional guidance for the industry relating to measures aimed at protecting the integrity of the debt research process.

Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at [kurt.schacht@cfainstitute.org](mailto:kurt.schacht@cfainstitute.org) or 212.756.7728; or Linda L. Rittenhouse at [linda.rittenhouse@cfainstitute.org](mailto:linda.rittenhouse@cfainstitute.org) or 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht

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