arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml);* or
- Send an email to *rule-comments@sec.gov. Please include File Number SR–CBOE–2014–086 on the subject line.*

Paper Comments

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

All submissions should refer to File Number SR–CBOE–2014–086. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number *SR–CBOE–2014–086* and should be submitted on or before December 15, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[12]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–27702 Filed 11–21–14; 8:45 am]

BILLING CODE 8011–01–P

[12] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–73623; File No. SR–FINRA–2014–048]

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

November 18, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on November 14, 2014, Financial Industry Regulatory Authority, Inc. (''FINRA'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

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

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

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

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

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

[2] 17 CFR 240.19b–4.

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

1. Purpose

Background

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

Currently, FINRA's research rules, NASD Rule 2711 (Research Analysts and Research Reports) and Incorporated NYSE Rule 472 (Communications with the Public) (the ''equity research rules''), set forth requirements to foster objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions. The equity research rules apply only to research reports that include analysis of an ''equity security,'' as that term is defined under the Exchange Act,[4] subject to certain exceptions.[5] The equity research rules were intended to restore public confidence in the objectivity of research and the veracity of research analysts, who are expected to function as unbiased intermediaries between issuers and the investors who buy and sell those issuers' securities.[6] The integrity of research had eroded due to the pervasive influences of investment banking and other conflicts during the market boom of the late 1990s.

In general, the equity research rules require disclosure of conflicts of interest

[3] The proposed rule change reflects proposed amendments to FINRA's equity research rules set forth in a companion filing to the proposed rule change (the ''equity research filing''). *See* Exchange Act Rel. No. 34–[] (Nov. 17, 2014) (SR–FINRA–2014–047).

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

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

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

in research reports and public appearances by research analysts. The equity research rules further prohibit conflicted conduct—investment banking personnel involvement in the content of research reports and determination of analyst compensation, for example—where the conflicts are too pronounced to be cured by disclosure. Several requirements in the equity research rules implement provisions of the Sarbanes-Oxley Act of 2002 (''Sarbanes-Oxley''), which mandates separation between research and investment banking, proscribes conduct that could compromise a research analyst's objectivity and requires specific disclosures in research reports and public appearances.[7] The Sarbanes-Oxley research provisions do not apply to debt research.

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

The Joint Report also recommended changes to the equity research rules to strike a better balance between ensuring objective and reliable research on the one hand, and permitting the flow of information to investors and minimizing costs and burdens to members on the other.[10] The proposed rule change is informed by FINRA's experience with and the effectiveness of the equity research rules and incorporates many of the findings and recommendations from the Joint Report.

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

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

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

Following the consolidation of NASD and the member regulatory functions of NYSE Regulation, Inc. into FINRA, and as part of the process to develop the consolidated FINRA rulebook,[14] FINRA conducted a comprehensive review of all of its research rules and considered the appropriateness of adopting a dedicated rule to address potential conflicts of interest in the publication and distribution of debt research reports. In addition to its examination findings, and later, the conclusions of the GAO Report, several other factors also weighed in FINRA's decision to propose dedicated debt research conflict of interest rules. Misconduct in the sale of auction rate securities (*i.e.,* debt

[7] 15 U.S.C. 78*o*–6.

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

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

[10] The basis for the recommended changes to the equity research rules is described in more detail in the equity research filing. *See supra* note 3.

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

[12] *Notice to Members* 06–36 (July 2006).

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

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

traders pressured research analysts to help prop up the market with optimistic research) demonstrates that potential conflicts of interest in the publication and distribution of debt research can exist just as they do for equity research.[15] Also, the reliability of credit agency ratings was called into question during the financial crisis that began in 2008. Furthermore, the Dodd-Frank legislation in response to that crisis has resulted in rules by the Commodity Futures Trading Commission (''CFTC'') to govern conflicts of interest regarding non-security-based swaps and commodities research, and the SEC has proposed rules that would require security-based swap dealers and major security-based swap participants to adopt written policies and procedures to address conflicts related to security-based swaps and research. Based on the foregoing considerations, and consistent with the regulatory trend to require mitigation and transparency of conflicts related to all types of investment research, FINRA believes it necessary and appropriate to provide better protections to recipients of debt research, particularly less sophisticated investors. FINRA's belief is buttressed by observations of retail investment in debt securities. For example, FINRA TRACE data shows that from 2007 through 2013, retail-sized transactions (defined to mean trades with a face value of less than $100,000) in corporate bonds increased approximately 97 percent to about 16,000 daily trades.

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

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

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

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

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

As noted above, the proposed rule change adopts a tiered approach that, in general, would provide retail debt research recipients with extensive protections similar to those provided to recipients of equity research under current and proposed FINRA rules, with modifications to reflect the different nature and trading of debt securities. Proposed FINRA Rule 2242 would differ from FINRA's current equity research rules in three key respects.[18] First, the proposed rule change would delineate the prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel. These restrictions take into account the need to ration a debt research analyst's resources among the multitude of debt securities, the limitations on price discovery in the debt markets, and the need for trading personnel to perform credit risk analyses with respect to

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

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

[17] *See supra* notes 8 and 9.

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

current and prospective inventory. Second, the proposed rule change would exempt debt research provided solely to institutional investors from many of the structural protections and prescriptive disclosure requirements that apply to research reports distributed to retail investors. FINRA believes that this tiered approach is appropriate as it recognizes the needs of institutional market participants who rely on timely market color, trading strategies and other communications from the trading desk. Third, in addition to the exemption for limited investment banking activity found in the current and proposed equity research rules, the proposed rule change has a similar additional exemption for limited principal trading activity. The proposed rule change, in general, would exempt members that engage in limited investment banking activity or those with limited principal trading activity and revenues generated from debt trading from the review, supervision, budget, and compensation provisions in the proposed rule related to investment banking activity or principal trading activity, respectively.

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

Proposed FINRA Rule 2242

Definitions

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

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

The proposed rule change would define the term ''debt research report'' as any written (including electronic) communication that includes an analysis of a debt security or an issuer of a debt security and that provides information reasonably sufficient upon which to base an investment decision, excluding communications that solely constitute an equity research report as defined in proposed Rule 2241(a)(11).[23] The proposed definition and exceptions noted below would generally align with the definition of ''research report'' in NASD Rule 2711, while incorporating aspects of the Regulation AC definition of ''research report.'' [24]

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

- Discussions of broad-based indices;
- commentaries on economic, political or market conditions;
- commentaries on or analyses of particular types of debt securities or characteristics of debt securities;
- technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price;
- recommendations regarding increasing or decreasing holdings in particular industries or sectors or types of debt securities; or
- notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent debt research report on the subject company that includes all current applicable disclosures required by the rule and that such debt research report does not contain materially misleading disclosure, including disclosures that are outdated or no longer applicable.

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

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

The proposed rule change would define the term ''debt security'' as any

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

[20] The proposed rule change also adopts defined terms to implement the tiered structure of proposed FINRA Rule 2242, including the terms ''qualified institutional buyer'' or ''QIB,'' which is part of the description of an institutional investor for purposes of the Rule, and ''retail investor.'' A detailed discussion of these definitions and the tiered structure of the proposed rule is available at pages 89 through 95.

[21] *See* proposed FINRA Rule 2242(a)(1).

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

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

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

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

The proposed rule change would define the term ''debt trader'' as a person, with respect to transactions in debt securities, who is engaged in proprietary trading or the execution of transactions on an agency basis.[27]

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

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

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

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

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

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

Identifying and Managing Conflicts of Interest

Similar to the proposed equity research rules, the proposed rule change contains an overarching provision that would require members to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to the preparation, content and distribution of debt research reports, public appearances by debt research analysts, and the interaction between debt research analysts and persons outside of the research department, including investment banking, sales and trading and principal trading personnel, subject companies and customers.[37] The proposed rule change then sets forth minimum requirements for those written policies and procedures. These provisions set out the fundamental obligation for a member to establish and maintain a system to identify and mitigate conflicts to foster integrity and fairness in its debt research products and services. The provisions are also intended to require firms to be more proactive in identifying and managing conflicts as new research products, affiliations and distribution methods emerge. This approach allows for some flexibility to manage identified conflicts, with some specified prohibitions and restrictions where

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

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

[27] *See* proposed FINRA Rule 2242(a)(5).

[28] *See* proposed FINRA Rule 2242(a)(6).

[29] *See* proposed FINRA Rule 2242(a)(8).

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

[31] *See* proposed FINRA Rule 2242(a)(10).

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

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

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

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

[36] *See* proposed FINRA Rule 2242(a)(16).

[37] *See* proposed FINRA Rule 2242(b)(1).

disclosure does not adequately mitigate them. Most of the minimum requirements have been experience tested and found effective in the equity research rules.

In general, the proposed rule change adopts, with slight modifications, the structural safeguards that the Joint Report found effective to promote analyst independence and objective research in the equity research rules, but in the form of mandated policies and procedures with some baseline proscriptions.[38] FINRA believes this approach will impose less cost than a pure prescriptive approach by requiring members to adopt a compliance system that aligns with their particular structure, business model and philosophy. FINRA notes that the approach is consistent with FINRA's general supervision rule, which similarly provides firms flexibility to establish and maintain supervisory programs best suited to their business models, reasonably designed to achieve compliance with applicable federal securities law and regulations and FINRA rules.[39] The proposed rule change introduces a distinction between sales and trading personnel—institutional sales representatives and sales traders—and persons engaged in principal trading activities, where the conflicts addressed by the proposal are of most concern.

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

Prepublication Review

The required policies and procedures must, at a minimum, be reasonably designed to prohibit prepublication review, clearance or approval of debt research by persons involved in investment banking, sales and trading or principal trading, and either restrict or prohibit such review, clearance and approval by other non-research personnel other than legal and compliance.[41] The policies and procedures also must prohibit prepublication review of a debt research report by a subject company, other than for verification of facts.[42] Similar provisions in the equity rules have proven effective to ensure independence of the research department, and FINRA believes that the objectivity of debt research could be compromised to the extent conflicted persons, *e.g.,* those involved in investment banking and trading activities, have an opportunity to review and comment on the content of a debt research report. The proposed rule change would allow limited review by the subject company because it is sometimes in a unique position to verify facts; otherwise, FINRA believes research analysts should confirm that purported facts are based on other reliable information. The proposed rule change allows sections of a draft debt research report to be provided to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or to the subject company for factual review, so long as: (a) The sections of the draft debt research report submitted do not contain the research summary, recommendation or rating; (b) a complete draft of the debt research report is provided to legal or compliance personnel before sections of the report are submitted to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company; and (c) if, after submitting sections of the draft debt research report to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company, the research department intends to change the proposed rating or recommendation, it must first provide written justification to, and receive written authorization from, legal or compliance personnel for the change. The member must retain copies of any draft and the final version of such debt research report for three years after publication.[43]

Coverage Decisions

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

Solicitation and Marketing of Investment Banking Transactions

A member's written policies and procedures also must, at a minimum, restrict or limit activities by debt research analysts that can reasonably be expected to compromise their objectivity.[45] This includes prohibiting participation in pitches and other solicitations of investment banking

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

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

[40] *See* proposed FINRA Rule 2242(b)(2).

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

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

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

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

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

services transactions and road shows and other marketing on behalf of issuers related to such transactions. The proposed rule change adopts Supplementary Material that incorporates an existing FINRA interpretation for the equity research rules that prohibits in pitch materials any information about a member's debt research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable debt research coverage.[46] By way of example, the Supplementary Material explains that FINRA would consider the publication in a pitch book or related materials of an analyst's industry ranking to imply the potential outcome of future research because of the manner in which such rankings are compiled. The Supplementary Material further notes that a member would be permitted to include in the pitch materials the fact of coverage and the name of the debt research analyst, since that information alone does not imply favorable coverage. FINRA notes that, consistent with existing guidance on the equity research rules, debt research analysts may listen to or view a live webcast of a transaction-related road show or other widely attended presentation by investment banking to investors or the sales force from a remote location, or another room if they are in the same location.[47]

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

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

Supervision

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

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

Budget and Compensation

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

With respect to compensation determinations, a member's written policies and procedures must prohibit compensation based on specific investment banking services or trading transactions or contributions to a firm's investment banking or principal trading activities and prohibit investment banking and principal trading personnel from input into the compensation of debt research analysts.[53] Further, the firm's written policies and procedures must require that the compensation of a debt research analyst who is primarily responsible for the substance of a research report be reviewed and approved at least annually by a committee that reports to a member's board of directors or, if the member has no board of directors, a senior executive officer of the member.[54] This committee may not have representation from investment banking personnel or persons engaged in principal trading activities and must consider the following factors when reviewing a debt research analyst's compensation, if applicable: The debt research analyst's individual performance, including the analyst's productivity and the quality of the debt research analyst's research; and the overall ratings received from customers and peers (independent of the member's investment banking department and persons engaged in principal trading activities) and other independent ratings services.

Neither investment banking personnel nor persons engaged in principal trading activities may give input with respect to the compensation determination for debt research analysts. However, sales and trading personnel may give input to

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

[47] *See* NASD *Notice to Members* 07–04 (January 2007) and NYSE *Information Memo* 07–11 (January 2007).

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

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

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

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

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

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

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

debt research management as part of the evaluation process in order to convey customer feedback, provided that final compensation determinations are made by research management, subject to review and approval by the compensation committee.[55] The committee, which may not have representation from investment banking or persons engaged in principal trading activities, must document the basis for each debt research analyst's compensation, including any input from sales and trading personnel.

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

Personal Trading Restrictions

Under the proposed rule change, a member's written policies and procedures must restrict or limit trading by a ''debt research analyst account'' in securities, derivatives and funds whose performance is materially dependent upon the performance of securities covered by the debt research analyst.[56] The procedures must ensure that those accounts, supervisors of debt research analysts and associated persons with the ability to influence the content of debt research reports do not benefit in their trading from knowledge of the content or timing of debt research reports before the intended recipients of such research have had a reasonable opportunity to act on the information in the report.[57] Furthermore, the procedures must generally prohibit a debt research analyst account from purchasing or selling any security or any option or derivative of such security in a manner inconsistent with the debt research analyst's most recently published recommendation, except that they may define circumstances of financial hardship (*e.g.,* unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account) in which the firm will permit trading contrary to that recommendation. In determining whether a particular trade is contrary to an existing recommendation, firms may take into account the context of a given trade, including the extent of coverage of the subject security. While the proposed rule change does not include a recordkeeping requirement, FINRA expects members to evidence compliance with their policies and procedures and retain any related documentation in accordance with FINRA Rule 4511.

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

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

Retaliation and Promises of Favorable Research

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

Joint Due Diligence With Investment Banking Personnel

The proposed rule change establishes a proscription with respect to joint due diligence activities—*i.e.,* due diligence by the debt research analyst in the presence of investment banking department personnel—during a specified time period. Specifically, the proposed rule change states that FINRA interprets the overarching principle requiring members to, among other things, establish, maintain and enforce written policies and procedures that address the interaction between debt research analysts, banking and subject companies,[61] to prohibit the performance of joint due diligence prior to the selection of underwriters for the investment banking services transaction.[62] FINRA understands that in some instances, due diligence activities take place even before an issuer has awarded the mandate to manage or co-manage an offering. There is heightened risk in those circumstances that investment bankers may pressure analysts to produce favorable research that may bolster the firm's bid to become an underwriter for the offering. Once the mandate has been awarded, FINRA believes joint due diligence may take place in accordance

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

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

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

[58] *See* proposed FINRA Rule 2242.10.

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

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

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

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

with appropriate written policies and procedures to guard against interactions to further the interests of the investment banking department. At that time, FINRA believes that the efficiencies of joint due diligence outweigh the risk of pressure on debt research analysts by investment banking.

Communications Between Debt Research Analysts and Trading Personnel

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

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

Therefore, the proposed rule change would permit sales and trading and principal trading personnel to communicate customers' interests to a debt research analyst, so long as the debt research analyst does not respond by publishing debt research for the purpose of benefiting the trading position of the firm, a customer or a class of customers.[65] In addition, debt research analysts may provide customized analysis, recommendations or trade ideas to sales and trading and principal trading personnel and customers, provided that any such communications are not inconsistent with the analyst's currently published or pending debt research, and that any subsequently published debt research is not for the purpose of benefiting the trading position of the firm, a customer or a class of customers.[66]

The proposed rule change also would permit sales and trading and principal trading personnel to seek the views of debt research analysts regarding the creditworthiness of the issuer of a debt security and other information regarding an issuer of a debt security that is reasonably related to the price or performance of the debt security, so long as, with respect to any covered issuer, such information is consistent with the debt research analyst's published debt research report and consistent in nature with the types of communications that a debt research analyst might have with customers. In determining what is consistent with the debt research analyst's published debt research, a member may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the debt research analyst's published views.[67] Finally, debt research analysts may seek information from sales and trading and principal trading personnel regarding a particular debt instrument, current prices, spreads, liquidity and similar market information relevant to the debt research analyst's valuation of a particular debt security.[68]

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

Restrictions on Communications With Customers and Internal Sales Personnel

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

Consistent with the prohibition on investment banking department personnel directly or indirectly directing a debt research analyst to engage in sales or marketing efforts related to an investment banking services transaction or directing a debt research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction, no debt research analyst may engage in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction. These provisions are intended to allow debt research analysts to educate investors and internal sales personnel about an investment banking transaction in fair and balanced manner, in a setting that promotes candor by the debt research analyst.[71]

Content and Disclosure in Debt Research Reports

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

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

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

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

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

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

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

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

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

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

research rules that can be leveraged to meet the debt research disclosure requirements in the proposed rule change.

The proposed rule change would require members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in their debt research reports are based on reliable information.[72] FINRA has included this provision because it believes members should have policies and procedures to foster verification of facts and trustworthy research on which investors may rely. In addition, the policies and procedures must be reasonably designed to ensure that any recommendation or rating has a reasonable basis and is accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation or rating.[73] While there is no obligation to employ a rating system under the proposed rule, members that choose to employ a rating system must clearly define in each debt research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based. In addition, the definition of each rating must be consistent with its plain meaning.[74]

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

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

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

- If the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, any option, right, warrant, future, long or short position), and the nature of such interest;
- if the debt research analyst has received compensation based upon (among other factors) the member's investment banking, sales and trading or principal trading revenues;
- if the member or any of its affiliates: Managed or co-managed a public offering of securities for the subject company in the past 12 months; received compensation for investment banking services from the subject company in the past 12 months; or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;
- if, as of the end of the month immediately preceding the date of publication or distribution of a debt research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month), the member or its affiliates have received from the subject company any compensation for products or services other than investment banking services in the previous 12 months;[80]
- if the subject company is, or over the 12-month period preceding the date of publication or distribution of the debt research report has been, a client of the member, and if so, the types of services provided to the issuer. Such services, if applicable, shall be identified as either investment banking services, non-investment banking securities-related services or non-securities services;
- if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report;[81]
- if the debt research analyst received any compensation from the subject company in the previous 12 months; and
- any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of the publication or distribution of a debt research report.[82]

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

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

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

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

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

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

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

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

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

[79] *See* proposed FINRA Rule 2242(c)(4).

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

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

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

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

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

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

Disclosure of Compensation Received by Affiliates

The proposed rule change would provide that a member may satisfy the disclosure requirement with respect to receipt of non-investment banking services compensation by an affiliate by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the affiliate as to whether the affiliate received such compensation.[87] In addition, a member may satisfy the disclosure requirement with respect to the receipt of investment banking compensation from a foreign sovereign by a non-U.S. affiliate of the member by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the non-U.S. affiliate as to whether such non-U.S. affiliate received or expects to receive such compensation from the foreign sovereign. However, a member must disclose receipt of compensation by its affiliates from the subject company (including any foreign sovereign) in the past 12 months when the debt research analyst or an associated person with the ability to influence the content of a debt research report has actual knowledge that an affiliate received such compensation during that time period.

Disclosure in Public Appearances

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

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

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

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

Disclosure Required by Other Provisions

With respect to both research reports and public appearances, the proposed rule change would require that, in addition to the disclosures required under the proposed rule, members and debt research analysts must comply with all applicable disclosure provisions of FINRA Rule 2210 (Communications with the Public) and the federal securities laws.[91]

Distribution of Member Research Reports

The proposed rule change, like the proposed amendments to the equity research rules, codifies an existing interpretation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and provides

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

[84] *See* proposed FINRA Rule 2242(c)(5).

[85] *See* proposed FINRA Rule 2242(c)(6).

[86] *See* proposed FINRA Rule 2242(c)(7).

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

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

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

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

[91] *See* proposed FINRA Rule 2242(e).

additional guidance regarding selective—or tiered—dissemination of a firm's debt research reports. The proposed rule change requires firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that a debt research report is not distributed selectively to internal trading personnel or a particular customer or class of customers in advance of other customers that the member has previously determined are entitled to receive the debt research report.[92] The proposed rule change includes further guidance to explain that firms may provide different debt research products and services to different classes of customers, provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm discloses its research dissemination practices to all customers that receive a research product.[93]

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

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

Distribution of Third-Party Debt Research Reports

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

The proposed rule change would prohibit a member from distributing third-party debt research if it knows or has reason to know that such research is not objective or reliable.[95] FINRA believes that, where a member is distributing or ''pushing-out'' third-party debt research, the member must have written policies and procedures to vet the quality of the research producers. A member would satisfy the standard based on its actual knowledge and reasonable diligence; however, there would be no duty of inquiry to definitively establish that the third-party research is, in fact, objective and reliable.

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

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

- If the member or any of its affiliates managed or co-managed a public offering of securities for the subject company in the past 12 months; received compensation for investment banking services from the subject company in the past 12 months; or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;
- if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report; and
- any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of the publication or distribution of a debt research report.[97]

The proposed rule change would not require members to review a third-party debt research report prior to distribution if such debt research report is an independent third-party debt research

[92] *See* proposed FINRA Rule 2242(f).

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

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

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

[96] *See* proposed FINRA Rule 2242(g)(2).

[97] *See* proposed FINRA Rule 2242(g)(3).

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

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

Obligations of Persons Associated With a Member

The proposed rule change clarifies the obligations of each associated person under those provisions of the proposed rule that require a member to restrict or prohibit certain conduct by establishing, maintaining and enforcing particular policies and procedures. Specifically, the proposed rule change provides that, consistent with FINRA Rule 0140, persons associated with a member must comply with such member's written policies and procedures as established pursuant to the proposed rule. Failure of an associated person to comply with such policies and procedures shall constitute a violation of the proposed rule.[101] In addition, consistent with Rule 0140, the proposed rule states in Supplementary Material .08 that it shall be a rule violation for an associated person to engage in the restricted or prohibited conduct to be addressed through the establishment, maintenance and enforcement of written policies and procedures required by provisions of FINRA Rule 2242, including applicable Supplementary Material, that embed in the policies and procedures specific obligations on individuals. This Supplementary Material reflects FINRA's position that associated persons can be held liable for engaging in conduct that is proscribed by the member under FINRA rules. FINRA is clarifying this point in the Supplementary Material because the proposed rule change would adopt a policies and procedures approach to restricted and prohibited conduct with respect to research in place of specific proscriptions in the current equity research rules. Thus, for example, where the proposed rule requires a member to establish policies and procedures to prohibit debt research analyst participation in road shows, associated persons also are directly prohibited from engaging in such conduct, even where a member has failed to establish policies and procedures. FINRA believes that it is incumbent upon each associated person to familiarize themselves with the regulatory requirements applicable to his or her business and should not be able to avoid responsibility where minimum standards of conduct have been established for members.

Exemption for Members With Limited Investment Banking Activity

Similar to the equity research rules, the proposed rule change exempts from certain provisions regarding supervision and compensation of debt research analysts those members that over the previous three years, on average per year, have participated in 10 or fewer investment banking services transactions as manager or co-manager and generated $5 million or less in gross investment banking revenues from those transactions.[102] Specifically, members that meet those thresholds would be exempt from the requirement to establish, maintain and enforce policies and procedures that: Prohibit prepublication review of debt research reports by investment banking personnel or other persons not directly responsible for the preparation, content or distribution of debt research reports (but not principal trading or sales and trading personnel, unless the member also qualifies for the limited principal trading activity exemption); restrict or limit investment banking personnel from input into coverage decisions; limit supervision of debt research analysts to persons not engaged in investment banking; limit determination of the research department budget to senior management, excluding senior management engaged in investment banking activities; require that compensation of a debt research analyst be approved by a compensation committee that may not have representation from investment banking personnel; and establish information barriers to insulate debt research analysts from the review or oversight by persons engaged in investment banking services or other persons who might be biased in their judgment or supervision.[103] However, the proposed rule would require that members with limited investment banking activity establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in investment banking services activities or other persons, including persons engaged in principal trading or principal sales and trading activities, who might be biased in their judgment or supervision.[104] FINRA believes that even where research analysts need not be structurally separated from investment banking or other non-research personnel, they should not be subject to pressures that could compromise their independence and objectivity.

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

FINRA has found the thresholds in the current equity rule to be reasonable and appropriate: They reduce the challenges and costs of compliance for select provisions for those firms whose limited investment banking business significantly reduces the magnitude of conflicts that could impact investors. In addition, in the context of the equity rules, FINRA analyzed data to see if changing the magnitude of either or both thresholds—the number of transactions managed or co-managed or the amount of gross revenues generated from those transactions—yielded a more appropriate universe of exempted firms. FINRA reviewed and analyzed deal data

[98] *See* proposed FINRA Rule 2242(g)(4).

[99] *See* proposed FINRA Rule 2242(g)(5).

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

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

[102] *See* proposed FINRA Rule 2242(h).

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

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

for calendar years 2009 through 2011. FINRA reviewed firms that either managed or co-managed deals and earned underwriting revenues from those transactions during the review period. The analysis found that 155 of 317 such firms—or 49%—would have been eligible for the exemption. The data further suggested that incremental upward adjustments to the exemption thresholds would not result in a significant number of additional firms eligible for the exemption. For example, increasing both of the thresholds by 33% (to 40 transactions managed or co-managed and $20 million in gross revenues over a three-year period) would result in 18 additional exempted firms. As such, FINRA believes the current exemption produces a reasonable and appropriate universe of exempted firms. Since the exemption in the equity research rules relates to the same investment banking conflicts that debt research analysts face, FINRA believes the exemption, with its current thresholds, is equally reasonable and appropriate for the debt research rules.

Exemption for Limited Principal Trading Activity

FINRA believes it appropriate to provide an exemption from some provisions of the proposed rule that require separation of debt research from sales and trading and principal trading for firms whose limited principal trading operations results in an appreciably increased burden of compliance relative to the expected investor protection benefits. In general, FINRA believes that firms with modest potential principal trading profits pose lower risk of having sales and trading or principal trading personnel pressure debt analysts, provided other safeguards remain in place. The proposed rule change therefore includes an exemption from certain provisions regarding supervision and compensation of debt research analysts for members that engage in limited principal trading activity where: (1) In absolute value on an annual basis, the member's trading gains or losses on principal trades in debt securities are $15 million or less over the previous three years, on average per year; and (2) the member employs fewer than 10 debt traders; provided, however, such members must establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision.[105] Specifically, members that meet those thresholds would be exempt from the requirement to establish, maintain and enforce policies and procedures that: Prohibit prepublication review of debt research reports by principal trading or sales and trading personnel or other persons not directly responsible for the preparation, content or distribution of debt research reports (but not investment banking personnel, unless the firm also qualifies for the limited investment banking activity exemption); restrict or limit principal trading or sales and trading personnel from input into coverage decisions; limit supervision of debt research analysts to persons not engaged in sales and trading or principal trading activities, including input into the compensation of debt research analysts; limit determination of the research department budget to senior management, excluding senior management engaged in principal trading activities; require that compensation of a debt research analyst be approved by a compensation committee that may not have representation from principal trading personnel; and establish information barriers to insulate debt research analysts from the review or oversight by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision.[106]

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

In crafting the exemption, FINRA sought a rational principal debt trading revenue threshold for small firms where the conflicts addressed by the proposal might be minimized. FINRA further considered the ability of firms with limited personnel to comply with the provisions that require effective separation of principal debt trading and debt research activities. To those ends, FINRA reviewed and analyzed available TRACE and FOCUS data, particularly with respect to small firms (150 or fewer registered representatives). FINRA supplemented its analysis with survey results from 72 geographically diverse small firms that engage in principal debt trading in varying magnitudes. The survey sought more specific information on the nature of the firms' debt trading—the breakdown between trading in corporate versus municipal securities (which are excepted from the proposal) and the amount of ''riskless principal'' trading—as well as the number of debt traders, whether any of those traders write research or market commentary, and the prospective ability of firms to comply with the proposal's structural separation requirements.

Based on the data, FINRA analyzed the range of principal debt revenues generated by small firms and determined that $15 million would be a reasonable threshold for the exemption. However, because the revenue figure represents a net gain or loss (in absolute terms) from principal debt trading activity, the potential exists that a firm with substantial trading operations could have an anomalous year that yields net revenues under the threshold. Therefore, FINRA added as a backstop the second criterion of having fewer than 10 debt traders, to ensure the exemption applies only to firms with modest debt trading activity. Furthermore, based on the assessment, FINRA believes firms with 10 or more debt traders are more capable of dedicating a debt trader to writing research. FINRA notes that only eight of the 72 responding survey firms indicated that they have debt traders that write either research or market commentary—which is excepted from the definition of ''debt research report'' under the proposal—on debt securities. FINRA intends to monitor the research produced by firms that avail themselves of the exemption to assess whether the thresholds to qualify for the exemption are appropriate or should be modified.

Exemption for Debt Research Reports Provided to Institutional Investors

FINRA understands that, unlike in the equity market, institutional investors trading in debt securities tend to interact with broker-dealers in a manner more closely resembling that of a counterparty than a customer. FINRA further understands that these institutional investors value the timely flow of analysis and trade ideas related to debt securities, are aware of the types of potential conflicts that may exist

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

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

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

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

Specifically, the proposed rule would allow firms to distribute institutional debt research by negative consent to a person who meets the definition of a QIB [109] and where, pursuant to FINRA Rule 2111(b): (1) The member or associated person has a reasonable basis to believe that the QIB is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a debt security or debt securities; and (2) the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the member's recommendations pursuant to FINRA Rule 2111 and such affirmation is broad enough to encompass transactions in debt securities. The proposed rule change would require written disclosure to the QIB that the member may provide debt research reports that are intended for institutional investors and are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors. If the QIB does not contact the member and request to receive only retail debt research reports, the member may reasonably conclude that the QIB has consented to receiving institutional debt research reports.[110] FINRA interprets this standard to allow an order placer, *e.g.,* a registered investment adviser, for a QIB that satisfies the FINRA Rule 2111 institutional suitability requirements with respect to debt transactions to agree to receive institutional debt research on behalf of the QIB by negative consent.

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

To avoid a disruption in the receipt of institutional debt research, the proposed rule change would allow firms to send institutional debt research to any FINRA Rule 4512(c) account, except a natural person, without affirmative or negative consent for a period of up to one year after SEC approval while they obtain the necessary consents. Natural persons that qualify as an institutional account under FINRA Rule 4512(c) must provide affirmative consent to receive institutional debt research during this transition period and thereafter.[112]

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

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

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

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

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

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

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

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

research analysts and promises of favorable debt research also still apply with respect to research distributed to eligible institutional investors.[113] FINRA believes that, notwithstanding the sophistication of its recipients, minimum objectivity standards should apply to institutional debt research and members should not be encouraged to use debt research analysts for the purpose of soliciting and marketing investment banking transactions.

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

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

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

General Exemptive Authority

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

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

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[118] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change would promote increased quality, objectivity and transparency of debt research distributed to investors by requiring firms to identify and mitigate conflicts in the preparation and distribution of such research. FINRA further believes the rule will provide investors with more reliable information on which to base investment decisions in debt securities, while maintaining timely flow of information important to institutional market participants and providing those institutional investors with appropriate safeguards.

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

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

The proposed rule change would adopt a policies and procedures approach that allows members to implement a compliance system that

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

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

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

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

[117] *See* proposed FINRA Rule 2242(k).

[118] 15 U.S.C. 78*o* – 3(b)(6).

[119] *See* Joint Report, *supra* note 8 at 12–23.

[120] *See* GAO Report, *supra* note 9 at 11–15.

aligns with their particular structure and business models, without diminishing investor protection. FINRA believes that this proposed approach imposes less cost on members without reducing investor protections than does a purely prescriptive approach or ''one size fits all'' approach with respect to compliance. In addition, the proposed rule adopts a substantial portion of the equity research rules. FINRA believes that many of the same conflicts of interest are present in the publication and distribution of equity and debt research and that consistency among the debt and equity research rules will further minimize the burdens to members to comply with the proposed rule change.

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

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

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

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

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

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

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

The *Regulatory Notice* 12–09 Proposal sought comment on a proposed rule to govern the preparation and distribution of debt research pursuant to a tiered approach based on whether debt research is distributed to retail or institutional investors. Under the proposal, debt research distributed to retail investors would carry most of the same protections provided to recipients of equity research, while institutional investors could affirmatively opt in to a framework that would exempt such research from many of those provisions. FINRA received seven comments in response to the proposal.[121] Commenters suggested significant changes to the proposal, most notably with respect to the definitions of ''debt security'' and ''debt research report,'' the opt-in requirement for institutional investors, and the restrictions on input into debt research budget and compensation determinations by those involved in principal trading activities.

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

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

the proposal.[122] The comments focused on two primary issues: The higher tier definition of institutional investor and the restrictions on input by principal trading personnel into research budget and evaluation and compensation determinations. Despite specific requests in the *Regulatory Notice,* FINRA received little or no comment on the economic impact of the proposal or any particular provisions.

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

Definitions

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

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

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

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

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

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

FINRA continues to believe it imprudent to create a broad exception from the definition of ''debt research report'' based on the author or

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

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

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

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

Prepublication Review

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

First, FINRA notes that it has proposed to eliminate any prepublication review by investment banking or other persons not directly responsible for the preparation, content and distribution of equity research reports, other than legal and compliance personnel. FINRA believes that review of facts in a report by investment banking and other non-research personnel is unnecessary in light of the numerous other sources available to verify factual information, including the subject company. FINRA notes that such review may invite pressure on a research analyst that could be difficult to monitor. FINRA further notes that such factual review is not permitted under the terms of the Global Settlement [124] and that FINRA staff has seen no evidence that the factual accuracy of research produced by Global Settlement firms has suffered. Second, with respect to debt research, the proposal delineates certain permissible communications between debt research analysts and sales and trading and principal trading personnel necessary for each to effectively discharge their responsibilities and facilitate debt market trading. Among the allowable communications, a debt research analyst may seek information from sales and trading and principal trading personnel regarding a ''particular bond instrument, current prices, spreads, liquidity and similar market information relevant to the debt research analyst's valuation of a particular security.'' In light of these permissible communications, and the other reasons stated above, FINRA sees no compelling reason why a debt research analyst needs further factual review from sales and trading or principal trading personnel by sharing portions of a draft research report. FINRA believes that any incremental improvement in accuracy by permitting factual review by investment banking, principal trading or sales and trading personnel is outweighed by the increased risk of pressure on a research analyst and the prospect that the perceived objectivity of the research may be undermined. Therefore, the proposed rule change does not incorporate the commenter's suggestion.

Research Department Budget

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

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

FINRA appreciates the desire of firms to allocate research costs based on the revenues to which the research department contributes, but also sees a countervailing investor protection interest in firms managing conflicts between their revenue-producing operations and research. FINRA believes that the size and allocation of the research budget should be insulated from pressure by those business

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

segments. In the case of investment banking, FINRA believes the conflict is too pronounced to allow any consideration of investment banking revenues in determining the research department budget. However, given the vast array of debt securities and classes, FINRA believes it appropriate to allow some consideration of revenue streams in allocating research budget resources. Therefore, the proposed rule change would permit consideration of those revenues, provided that: (1) Senior management, other than persons engaged in principal trading or investment banking activities, makes the final research department budget determination; [125] and (2) the member establishes information barriers or other institutional safeguards to ensure that debt research analysts are insulated from the review, pressure or oversight by persons engaged in principal trading activities, among others.[126]

Debt Research Analyst Evaluation and Compensation

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

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

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

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

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

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

Prohibitions on Interactions With Investment Banking Personnel

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

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

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

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

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

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

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

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

Prohibitions on Interactions with Sales and Trading

The proposed rule change maintains a provision in the Notice Proposals that would require members to have written policies and procedures to prohibit certain interactions between debt research and sales and trading and principal trading personnel. The proposed rule change also delineates prohibited and permissible communications between those persons. In response to the *Regulatory Notice* 12–09 Proposal, SIFMA asked FINRA to clarify that the prohibition on attempting to influence analysts for the purpose of benefiting the firm, a customer or class of customers would not capture ordinary-course communications and is meant to prohibit non-research direction over the decision to publish a report and non-research direction over the views and opinions expressed in debt reports. The proposed rule provides that communications between debt research analysts and trading desk personnel that are not related to sales and trading, principal trading or debt research activities may take place without restriction, unless otherwise prohibited.[129]

SIFMA also recommended that FINRA include in the proposed rule text the language provided in *Regulatory Notice* 12–09 that, in assessing whether a debt research analyst's permissible communications are ''inconsistent'' with the analyst's published research, firms may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the analyst's published views. FINRA incorporated the suggested language into proposed FINRA Rule 2242.[130]

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

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

Conflicts Disclosure

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

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

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

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

[129] *See* proposed FINRA Rule 2242.03(c).

[130] *See* proposed FINRA Rule 2242.03(b)(3).

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

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

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

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

Third-Party Research Reports

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

FINRA notes that its equity research proposal contains identical requirements with respect to the selection and distribution of third-party research. FINRA believes it reasonable to require firms to conduct upfront due diligence on the quality of its third-party research providers, particularly given the lesser review obligations imposed prior to distribution. FINRA notes that Global Settlement firms had to have such procedures to select their independent research providers,[131] and FINRA does not believe it unreasonable to have some type of screening procedures to ensure, for example that the third-party provider is not being paid by the issuer or that the research has some kind of track record or good reputation. In fact, in a 2006 comment letter, SIFMA stated that firms should ''demand high standards'' from providers of third-party research.[132] FINRA further believes it appropriate for firms to disclose to investors any relationship, *e.g.,* an affiliate relationship, or other circumstances that rise to a material conflict of interest that could reasonably be seen as having influenced the choice of third-party research provider. FINRA believes this disclosure is consistent with the requirement to disclosure material conflicts of interest with respect to a firm's own research, and therefore will similarly promote objectivity and transparency of information provided to investors that may influence their investment decisions. FINRA notes that a firm may avoid the requirement to review third-party research for false or misleading statements if it chooses to distribute only independent third-party research.[133]

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

Institutional Investor Definition

The *Regulatory Notice* 12–09 proposal would have exempted from many of the rule's provisions debt research reports disseminated only to ''institutional investors,'' provided that those institutional investors had, prior to receipt of a debt research report, affirmatively notified the member in writing that they wished to forego treatment as a retail investor for the

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

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

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

purposes of the rule. ASIR, BDA and SIFMA found this provision unnecessarily burdensome and difficult to implement and track. The commenters noted that they already expend resources to document similar consents under FINRA's suitability rule and that the nature of research distribution makes it more challenging than the suitability rule to track and process all eligible institutional investors that have consented to receive institutional debt research. Commenters instead advocated an approach whereby persons or entities that otherwise meet the definition of ''institutional investor''—as defined in FINRA Rule 4512(c)—are presumed to have consented to the institutional debt research regime unless they affirmatively choose to receive the protections afforded recipients of retail debt research. Among other things, these commenters asserted that this alternative approach would be less costly and burdensome to administer and that the remaining protections afforded institutional debt research under the proposal, together with the content standards applicable to institutional communications pursuant to FINRA's Communications with the Public rules,[134] provide less sophisticated institutional investors adequate protections should they not to choose be treated as retail investors for the purposes of debt research.

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

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

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

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

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

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

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

believes the proposed rule change imposes a one-time small burden on such investors to provide written consent. Some firms indicated to FINRA that the consent could be obtained at the time of other required written authorizations. FINRA believes the one-year grace period will ease the transition to the new rules without disrupting the current flow of debt research to institutional clients.

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

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

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

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

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

Limited Investment Banking or Principal Trading Activities Exemptions

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

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

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

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

Effective Date

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

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

Within 45 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or

(ii) as to which the self-regulatory organization consents, the Commission will:

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

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

IV. Solicitation of Comments

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

Electronic Comments

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

Paper Comments

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

All submissions should refer to File Number SR–FINRA–2014–048. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–FINRA–2014–048 and should be submitted on or before December 15, 2014.

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

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–27701 Filed 11–21–14; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–73631; File No. SR–NYSEArca–2014–41]

Self-Regulatory Organizations; NYSE Arca, Inc.; Order Granting Approval of a Proposed Rule Change, as Modified by Amendments No. 1 and No. 4 Thereto, Relating to Listing and Trading of Shares of the Reality Shares DIVS Index ETF Under NYSE Arca Equities Rule 5.2(j)(3)

November 18, 2014.

I. Introduction

On April 11, 2014, NYSE Arca, Inc. (''Exchange'' or ''NYSE Arca'') filed with the Securities and Exchange Commission (''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'' or ''Exchange Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change to list and trade shares (''Shares'') of the Reality Shares DIVS Index ETF (''Fund'') under NYSE Arca Equities Rule 5.2(j)(3). The proposed rule change was published for comment in the **Federal Register** on April 30, 2014.[3] On May 6, 2014, the Exchange filed Amendment No. 1 to the proposed rule change, which amended and replaced the proposed rule change in its entirety.[4] On June 6, 2014, the Exchange filed Amendment No. 4 to the proposed rule change.[5] On June 13, 2014, pursuant to Section 19(b)(2) of the Act,[6] the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.[7] On July 29, 2014, the Commission instituted proceedings under Section 19(b)(2)(B) of the Act [8] to determine whether to approve or disapprove the proposed rule change.[9] In response to the Order Instituting Proceedings, the Commission received two comment letters on the proposal.[10] On October 23, 2014, the Commission designated a longer period for Commission action on the Order Instituting Proceedings.[11] This order grants approval of the proposed rule change, as modified by Amendments No. 1 and No. 4 thereto.

II. Description of the Proposal, as Modified by Amendments No. 1 and No. 4 Thereto

A. The Fund, Generally

The Exchange proposes to list and trade Shares of the Fund under NYSE Arca Equities Rule 5.2(j)(3), which

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[135] 17 CFR 200.30–3(a)(12).

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 72015 (Apr. 24, 2014), 79 FR 24475 (''Notice'').

[4] In Amendment No. 1, the Exchange clarified the valuation of investments for purposes of calculating net asset value, provided additional details regarding the dissemination of the Disclosed Portfolio, and made other minor technical edits to the proposed rule change. Amendment No. 1 provided clarification to the proposed rule change, and because it does not materially affect the substance of the proposed rule change or raise novel or unique regulatory issues, Amendment No. 1 is not subject to notice and comment.

[5] The Exchange filed Amendment No. 2 on June 4, 2014 and withdrew it on June 5, 2014, and filed Amendment No. 3 on June 5, 2014 and withdrew it on June 6, 2014. Amendment No. 4 supersedes both Amendments No. 2 and No. 3. In Amendment No. 4, the Exchange amended the proposal to reflect a change to the name of the Fund and the underlying index. Specifically, the Exchange replaced each reference in the proposal to the ''Reality Shares Isolated Dividend Growth Index ETF'' (the original name of the Fund) with a reference to the ''Reality Shares DIVS Index ETF.'' Similarly, the Exchange replaced each reference in the proposal to the ''Reality Shares Isolated Dividend Growth Index'' with a reference to the ''Reality Shares DIVS Index.'' Amendment No. 4 is a technical amendment and is not subject to notice and comment as it does not materially affect the substance of the filing.

[6] 15 U.S.C. 78s(b)(2).

[7] *See* Securities Exchange Act Release No. 72385, 79 FR 35205 (Jun. 19, 2014). The Commission designated a longer period within which to take action on the proposed rule change and designated July 29, 2014, as the date by which it should approve, disapprove, or institute proceedings to determine whether to disapprove the proposed rule change.

[8] 15 U.S.C. 78s(b)(2)(B).

[9] *See* Securities Exchange Act Release No. 72714, 79 FR 45574 (Aug. 5, 2014) (''Order Instituting Proceedings''). Specifically, the Commission instituted proceedings to allow for additional analysis of the proposed rule change's consistency with Section 6(b)(5) of the Act, which requires, among other things, that the rules of a national securities exchange be ''designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade,'' and ''to protect investors and the public interest.'' *See id.*

[10] *See* Letter from Eric R. Ervin, President, Reality Shares ETF Trust and Reality Shares Advisors, LLC, and President and CEO, Reality Shares, Inc., to Kevin M. O'Neill, Deputy Secretary, Commission, dated August 22, 2014 (''Reality Shares Letter 1''); Letter from Eric R. Ervin, President, Reality Shares ETF Trust and Reality Shares Advisors, LLC, and President and CEO, Reality Shares, Inc., to Arun Manoharan, Financial Economist, Commission, dated October 21, 2014 (''Reality Shares Letter 2'').

[11] *See* Securities Exchange Act Release No. 73417, 79 FR 64430 (Oct. 29, 2014).