

# SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-59254; File No. SR-FINRA-2008-054)

January 15, 2009

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change to Adopt FINRA Rule 5280 (Trading Ahead of Research Reports) in the Consolidated FINRA Rulebook

## I. Introduction

On October 29, 2008, the Financial Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to adopt NASD Interpretive Material 2110-4 (Trading Ahead of Research Reports) as a FINRA rule, subject to certain amendments. The proposed rule change was published for comment in the Federal Register on November 6, 2008.<sup>3</sup> The Commission received two comment letters in response to the proposed rule change. This order approves the proposed rule change.

## II. Description of the Proposed Rule Change

As part of the process of developing the new consolidated rulebook (“Consolidated FINRA Rulebook”),<sup>4</sup> FINRA proposed to adopt in the Consolidated FINRA Rulebook NASD

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 58905 (November 6, 2008), 73 FR 67237 (November 13, 2008) (SR-FINRA-2008-054) (notice).

<sup>4</sup> 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

Interpretive Material (“IM”) 2110-4 (Trading Ahead of Research Reports) with certain modifications.

IM-2110-4 states that it is conduct inconsistent with just and equitable principles of trade for a member to establish or adjust an inventory position in an exchange-listed security traded over-the-counter or a derivative of such security in anticipation of the issuance of a research report on that security. The IM further recommends – but does not require – that firms establish policies and procedures to develop and implement effective internal controls to isolate specific information within research and other relevant departments so as to prevent the trading department from utilizing advance knowledge of the issuance of research reports. Those members that choose not to establish such procedures bear the burden to show that changes in inventory positions in advance of research reports were not purposeful.<sup>5</sup>

The proposed rule change would amend the IM in three respects. First, it would extend the application of the IM to cover inventory positions with respect to any security – including debt – or derivative thereof, irrespective of whether the security is exchange-listed. FINRA believes the purpose of the IM – to prevent the manipulation of the supply of a security for the benefit of a firm and to the detriment of investors – applies equally to inventory positions in non-exchange-listed securities.

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Members”). For more information about the rulebook consolidation process, see FINRA Information Notice, March 12, 2008 (Rulebook Consolidation Process).

<sup>5</sup> Incorporated NYSE Rule Interpretation 401/01 includes aspects similar to IM-2110-4. FINRA deleted that Interpretation as part of an earlier filing to transfer NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade) and 2120 (Use of Manipulative, Deceptive or Other Fraudulent Devices) to the Consolidated FINRA Rulebook, as the conduct addressed in the Interpretation is subsumed by those rules. See Securities Exchange Act Release No. 58643 (September 24, 2008) 73 FR 57174 (October 1, 2008) (Order Approving SR-FINRA-2008-028).

Second, the proposed rule change would apply the rule only to circumstances where a member establishes or adjusts its inventory based on *non-public* advance knowledge of the content or timing of a research report in that security. As such, it would not be a violation of the rule for a member to increase or decrease inventory of a security based on publicly available information regarding the likely timing of a research report. By way of example, when a member's trading desk adjusts an inventory position in anticipation of a research report because of a publicly discernible trend that a member's report tends to follow an earnings announcement, the prohibitions of the rule would not be triggered. However, having knowledge of a publicly discernible trend is not a viable alternative basis for the member's trading desk to adjust its inventory position when the trading desk is also the recipient of *non-public* advance knowledge of the content or timing of a research report in that security.

Finally, the proposal would eliminate the option to establish internal controls to manage the flow of information between the research and trading departments and instead mandate that firms establish policies and procedures reasonably designed to restrict or limit the information flow between research department personnel, or other persons with knowledge of the content or timing of a research report, and trading department personnel, so as to prevent trading department personnel from utilizing non-public advance knowledge of the issuance or content of a research report for the benefit of the member or any other person.

FINRA believes that a member should have an affirmative obligation to manage conflicts of interest in its trading of securities. Moreover, this approach is more consistent with existing and proposed rules regarding supervision and the requirements of NASD Rule 2711 and NYSE Rule 472 to eliminate conflicts involving the publication and distribution of research reports.

### III. Comments

The SEC received two comment letters.<sup>6</sup> The commenters' concerns, as well as FINRA's responses are discussed below.

The first comment letter expressed general support for the proposed rule change, but requested a few clarifications. First, the commenter sought clarification that the term "research report" in the proposed rule change has the same definition as that in NASD Rule 2711(a)(9). The latter defines research report as "any written (including electronic) communication that includes an analysis of equity securities of individual companies or industries, and that provides information sufficient upon which to base an investment decision." Rule 2711(a) also includes several exceptions to the definition, among them communications limited to commentaries on economic, political or market conditions.

FINRA responded that the term "research report" in the proposed rule change is intended to be much broader than that in NASD Rule 2711(a)(9) and is meant to cover adjustments to inventory positions based on non-public knowledge of the content or timing of both *debt* and equity research.<sup>7</sup> The proposed rule change differs in objective from NASD Rule 2711(a)(9) and is intended to "enhance investor protection and market integrity by deterring member firms from improperly accumulating or otherwise altering investor positions in securities" based on non-public advance knowledge of the content or timing of a research report in those securities. FINRA interprets the term research report in proposed FINRA Rule 5280 to cover any written information from the research department that a reasonable person would expect to result in a transaction based on that information. Thus, to the extent a reasonable person would expect that

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<sup>6</sup> Letter from Amal Aly, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association ("SIFMA"), December 5, 2008; Letter from Peter C. Chepucavage, General Counsel, Plexus Consulting, LLC, January 12, 2009.

a communication containing market commentary would result in a transaction in a particular security or securities, a member could not establish or adjust its inventory in those securities based on non-public advance knowledge of that communication or the timing of its public release. Based on these reasons, FINRA declined the commenter's additional request that the proposal be narrowed to cover only those actions taken by a member firm to adjust its inventory based upon advance non-public knowledge of material investment conclusions, such as ratings or price targets.

Second, the commenter requested that FINRA confirm that the requirement in subparagraph (b) of the proposal to establish, maintain and enforce certain policies and procedures is not meant to (1) limit or restrict communications between sales and trading personnel and research personnel concerning an analyst's published views or (2) to require that such communications must be pre-cleared or monitored.

FINRA responded that the proposed rule sets forth an unambiguous supervision standard that "a member must establish, maintain and enforce policies and procedures reasonably designed to restrict or limit the information flow between research department personnel, or others with knowledge of the content or timing of a research report, and trading department personnel, so as to prevent trading department personnel from utilizing non-public advance knowledge of the issuance or content of a research report for the benefit of the member or any other person." FINRA views the supervisory standard in the proposal as purposefully flexible, to allow firms to tailor their policies and procedures to their size, structure, business model and compliance system. As such any number of specific policies and procedures may be appropriate to satisfy the standard. Thus, absent ambiguity in the standard, FINRA believes it inappropriate

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See Letter from Philip Shaikun, Associate Vice President and Associate General Counsel, FINRA, January 2, 2008.

to opine on the adequacy of one or more elements of potentially many approaches that could satisfy the rule's supervision requirement.

The second comment letter expressed concern that while the proposed rule addresses that a broker-dealer cannot trade ahead of its own research report, the broker-dealer's customers and potential customers should also be so prohibited and that all customers and potential customers should get the research report at the same time. Further, the commenter indicated that the issue of whether the public should simultaneously get such reports should be explored and addressed. Per discussion, FINRA noted that the commenter's concerns are more appropriate to and are addressed in FINRA's proposed "Research Registration and Conflict of Interest Rules."<sup>8</sup>

#### IV. Discussion and Findings

After careful review of the proposed rule change, the comments and FINRA's response to the comments, the Commission finds that the proposed rule change is consistent with the requirements of the Act, and the rules and regulations thereunder that are applicable to a national securities association.<sup>9</sup> In particular, the Commission believes the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>10</sup> which requires, among other things that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and questionable principles of trade, and, in general, to protect investors and the public interest. The Commission believes that the proposed rule change will protect the investing public by preventing firms from utilizing non-public advance knowledge of

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<sup>8</sup> See, FINRA NTM 08-55, October 2008.

<sup>9</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition and capital formation. See 15 U.S.C. 78c(f).

<sup>10</sup> 15 U.S.C. 78o-3(b)(6).

the timing or content of a research report to benefit its own trading to the detriment of its customers. Moreover, the Commission believes the proposed rule change further would clarify and streamline NASD IM-2110-4 for adoption as a FINRA Rule in the Consolidated FINRA Rulebook.<sup>11</sup> NASD IM-2110-4 has previously been found to meet the statutory requirements, and FINRA believes the rule has since proven effective in achieving statutory mandates.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>12</sup> that the proposed rule change (SR-FINRA-2008-054) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>13</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>11</sup> See supra note 4.

<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> 17 CFR 200.30-3(a)(12).