United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

January 24, 2011

SUMITTED VIA EMAIL

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st St, NW
Washington, D.C. 20581

RE: RIN 3038-AC96: Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers

Dear Mr. Stawick:

The purpose of this letter is to express support for, and offer enhancements to, the proposed rules to implement Section 732 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Alleviating conflicts of interest is central to the establishment of a fair, economically sound, and robust financial system. The Commission should take strong measures to ensure that research and trading operations operate without the distortions that can result from decision making tainted by conflicts of interest.

Title VII of the Dodd-Frank Act is premised on the basic tenets of transparency and fairness as essential elements of financial reform. Its provisions are intended to: (1) increase fairness for market participants by providing trade transparency and reducing conflicts of interest; (2) reduce risks to firms and the financial system by ensuring adequate capital and margin requirements for firms that make trades; and (3) combat price manipulation and systemic risk by making trading information available to regulators.

Section 732 focuses generally on the fairness element of reform by directing the Commission to require futures commission merchants and introducing brokers to: (1) implement "safeguards" against information leaking from its research department to its traders or from having its research impermissibly influenced by the firm's trading concerns, and (2) address "such other issues as the Commission deems appropriate."[1] Further, Section 732 requires each futures commission merchant to designate a Chief Compliance Officer who would fulfill such requirements as the Commission or registered futures association adopt by regulation or rule.[2]

[1] Dodd Frank Act, § 732.
[2] Id.

Collectively, these two requirements should ensure the integrity of research reports and investor confidence by guarding against firms' skewing their research reports for their own trading advantage or taking advantage of their market-moving research.

REGULATION OF IMPROPER INFLUENCES AND FRONT-RUNNING RESEARCH REPORTS

In many respects, the proposed rule is similar to longstanding protections in other markets that have attempted – with varied degrees of success[3] – to restrict firms from impermissibly profiting from their own market-moving research reports.[4]

In 2002, Congress and the financial regulators were very concerned with investment bankers and traders providing a bias or otherwise undermining the objectivity of the research reports prepared and distributed by their firms.[5] These concerns led to the adoption of[6] and subsequent statutorily mandated modifications to[7] NASD Rule 2711, which appears to be the model for the rule proposed by the Commission here.

Importantly, since 2002, regulators have further expanded their protections regarding research activities. For example, in October 2008, the Financial Industry Regulatory Authority (FINRA) filed a proposed rule with the Securities and Exchange Commission (SEC) that expanded its restrictions on trading around research reports.[8] That rule, which was approved by the SEC[9] and became effective in April 2009, prohibits firms from changing their trading positions in anticipation of the issuance of a research report on a security, and mandates that firms establish policies and procedures reasonably designed to restrict the information flow between research department personnel (or other people with knowledge of the timing or content of research reports) and trading department personnel.[10] Thus, securities regulators are now appropriately focused on not just preventing biased research reports, but also preventing firms'

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[3] *See, e.g.*, SEC Fact Sheet on Global Analyst Research Settlements, Sec. and Exch. Comm'n (Apr. 28, 2003) available at http://www.sec.gov/news/speech/factsheet.htm (detailing reforms at the 10 largest US financial firms as a result of conflicts of interest in research); *see also*, Hans G. Heidle and Xi Li, Is There Evidence of Front-Running Before Analyst Recommendations? An Analysis of the Quoting Behavior of Nasdaq Market Makers, Nov. 10, 2003, available at http://www.afajof.org/pdfs/2004program/UPDF/P177_Market_MicroStructure.pdf (finding that some market makers changed their trading activities immediately prior to the release of research reports by their firms).

[4] *See, e.g., Sec. and Exch. Comm'n v. Capital Gains Res. Bureau, Inc.*, 375 U.S. 180, 196 (1963) (holding that an investment adviser could be required to make "full and frank disclosure of his practice of trading on the effect of his recommendations."); *see also* NASD Rule 2711 and NYSE Rule 472.

[5] *See, e.g.*, Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules, (Dec. 2005) available at http://www.finra.org/web/groups/industry/@ip/@issues/@rar/documents/industry/p015803.pdf (detailing the types of conflicts facing research analysts at firms engaged in investment banking and trading); *see also, In the Matter of the Application of Frank P. Quattrone*, Exchange Act Rel. No. 53547 (Mar. 24, 2006) (describing an investigation into research analyst conflicts of interest at Credit Suisse First Boston, LLC starting in 2002).

[6] Exchange Act Rel. No. 34-45908 (May 10, 2002) (adopting NASD Rule 2711).

[7] Exchange Act Rel. No. 34-48252 (Jul. 29, 2003) (adopting changes to NASD Rule 2711 to comply with new Section 15D to the Securities Exchange Act of 1934 (Exchange Act)).

[8] Exchange Act Rel. No. 58905 (Nov. 6, 2008).

[9] Exchange Act Rel. No. 59254 (Jan. 15, 2009).

[10] FINRA Rule 5280 (Trading Ahead of Research Reports).

traders from misusing their inside information about pending research reports to their trading advantage.

Much like in the securities markets, the National Futures Association (NFA) has rules: (1) requiring research reports to not mislead by commission or omission,[11] and (2) restricting firms from using information regarding a research report to their advantage over their customers.[12] However, neither the Commission nor the NFA have rules that address the potential conflicts surrounding research reports with the same degree of specificity as the securities regulators.

PROPOSED RULES

The proposed rules would establish specific restrictions on the communications between research personnel, on the one hand, and trading and clearing personnel, on the other. Put simply, the rule seeks to isolate research analysts from improper conflicts in a number of ways. First, the proposed rules would broadly state that "[n]on-research personnel shall not influence the content of a research report of the futures commission merchant or the introducing broker."[13] Second, analysts' communications with trading and clearing personnel would be restricted.[14] Third, analysts' firms would be prohibited from using the analysts' contributions to their firms' trading and clearing businesses as a factor in reviewing the analysts' compensation.[15] Fourth, analysts would be protected from having traders or clearing employees retaliate against them for making an "adverse, negative, or unfavorable" research report or from saying something negative at a public appearance.[16]

In addition to these efforts to isolate the analysts themselves, the proposed rules would restrict the conflicts facing analysts by: (1) prohibiting covered firms from promising favorable research or threatening to change research as consideration or as a means to induce business or compensation, and (2) requiring disclosure of any financial interests held by the analyst in the derivatives the analyst follows.[17] Further, firms would be required to make meaningful disclosures on research reports they distribute—even if those reports are prepared by third-parties.[18]

Collectively, these provisions will help ensure the integrity of information provided by analysts, and should be adopted. The Commission may also want to consider adding to the proposed rules provisions akin to FINRA Rule 5280 as a way to further improve the quality of research reports and the integrity of the marketplace.

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[11] NFA Compliance Rule 2-29.
[12] *See generally*, NFA Compliance Rule 2-4.
[13] Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers, 75 Fed. Reg. 70152, 70158 (proposed Nov. 17, 2010).
[14] Id.
[15] Id.
[16] Id., at 70159.
[17] Id.
[18] Id.

The proposed rules would also direct all futures commission merchants and introducing brokers to have written policies and procedures that "mandate the disclosure to customers of any material incentives and any material conflicts of interest regarding the decision" of the customer to trade or clear a derivatives transaction.[19] This provision could not only help ensure the integrity of research. It should also be used to impose a broader duty on futures commission merchants and introducing brokers—namely, to more completely disclose any adverse interest.

The Permanent Subcommittee on Investigations has identified several instances where firms bet against securities they sold to customers without their customers' full knowledge. In some instances, firms went so far as to design products that were intended to fail, and then sold them to unsuspecting clients in ways that allowed them to profit at their clients' expense. If the disclosure requirement under the proposed rule is interpreted appropriately, it should help curtail these types of conflicted self-dealing transactions. The Commission should make it clear that it intends to interpret the rule robustly to require meaningful disclosures of material conflicts of interest in all types of written and oral communications designed to, or that reasonably could encourage a client to, engage in a transaction. To encourage compliance, the Commission should develop a number of examples of potential or actual conflicts of interest that should be disclosed to investors.

In addition, the Commission's proposed rule would place a number of limitations on the impact of any affiliated swap dealer or major swap participant to influence the decision-making by the clearing unit's personnel in a number of areas. These provisions should be viewed as complementary to rules adopted under Section 726 of the Dodd-Frank Act, which are likewise intended to help ensure the transparency and integrity of clearing operations. These two sets of conflicts of interest protections, in conjunction with the Commission's previously existing authorities and others provided under the Dodd-Frank Act, will help combat trading goals from influencing firms' clearing activities.

CONCLUSION

Thank you for the opportunity to comment on these proposed rules.

Sincerely,

Carl Levin
Chairman
Permanent Subcommittee on Investigations

[19] Id.