

The Ill-Conceived Rule of Research – Trading Ahead of Reports

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Last Thursday, the SEC published a proposal by FINRA to adopt into its Consolidated Rulebook Interpretive Material 2110-4, a rule originally adopted by the NASD in 1995. The new proposal would essentially adopt the old rule with some modifications. The old rule was a bad idea. Reinstating the rule in the Consolidated Rulebook, as modified, makes matters worse.

IM 2110-4 prohibits broker-dealers from establishing or adjusting a position in a security in anticipation of a research report to be issued on that security. The current rule applies only to exchange-listed securities traded over-the-counter, or derivatives on that security. Since NASDAQ was not an exchange in 1995, the original rule did not apply to securities listed on NASDAQ. The IM recommended, but did not require, member firms to establish policies and procedures to prevent information leakage from research onto the trading desk. This usually means establishing some sort of “Chinese Wall.”

The proposed rule would modify IM 2110-4 in three ways. First, it would cover any security, including debt, and any derivative, that is the subject of a research report, whether or not the security is exchange-listed. Second, the rule would clarify that it applies where the trading desk reacts to non-public information. If, for example, it is well-known that a firm always issues a research report shortly after an earnings announcement, the trading desk could anticipate the issuance of a report, provided that they had no actual knowledge of its content or timing. Third, firms are now required to establish procedures to prevent their trading departments from taking advantage of non-public advance knowledge of the issuance or content of a research report.

Markets are essentially a way for market participants to communicate their opinion about the value of a particular security. Markets work best when their participants base trading decisions on good information because that will result in prices that better reflect the intrinsic worth of any particular security. In turn, markets that do a good job of setting prices benefit society by facilitating a more efficient allocation of resources. Resources flow to their most valuable uses only if markets are establishing values correctly.

However, good information cannot be produced without cost. This fact of life means that people will not expend the effort and cost to obtain good information

unless they believe they can make a profit from the endeavor. So, as a society, we encourage people to expend the requisite cost and effort of mining for information by allowing them to profit from its use and prohibiting its theft by others.

When it comes to securities, good information is obtained through research. We encourage people to engage in research by allowing them to use their information to make trades. If the research is sound, the trades will be profitable, enabling them to cover the cost of research. The use of information in this case moves markets in the right direction leading to a more efficient allocation of resources. We should all be better off.

The securities laws dealing with the use or misuse of information therefore reflect a tension between two competing principles. We encourage people to engage in research and therefore obtain an information advantage over other market participants. We permit investors who have obtained an information advantage from research to make a profit from their work through trades with less well-informed market participants.

On the other hand, we discourage the use of information that has been obtained through a privileged position, rather than research. So, a corporate director who obtains information from listening at a board meeting has not performed socially beneficial research to obtain the information. The information in this case belongs to someone else – the corporation and its shareholders. Its use by the director to make profits amounts to a form of theft. Similarly, we prohibit front-running, which is making profitable trades based on the knowledge that a block trade is imminent. The profits from this information belong to the customer submitting the order for the block, not the front-runner. The misuse of that information by the front-runner is misappropriation, a form of theft.

IM 2110-4 throws a money wrench into the works. A FINRA member firm that expends the cost and effort to produce research is prohibited from profiting from it by making trades. In contrast, investment management firms are not prohibited from making trades on the basis of their research. Nor are investment managers prohibited from selling research after they have exploited any favorable market opportunities to be gleaned from the research.

Why would we do this? The rule suggests that the information contained in research reports belongs to the customers of the broker-dealer. But, why is this true? The researching broker-dealer does not obtain the information contained in a research report from its customers. Instead, it pays investment analysts to evaluate securities and produce reports.

Presumably, the theory behind the rule, if it has any merit at all, is that the information in the research report is valuable to the trading desk, not because of

what it contains, but because the desk predicts that the firm's customers will react in a certain way to the research report. Alternatively, if the problem is that customers think they are paying for a "first look" at the information before anyone else can use it, surely the best way to regulate the conduct would be through good disclosure. Customers offended by the firm's use of research will take their business elsewhere. Or, maybe they will be so impressed by the firm's willingness to eat its own cooking that they will send more of their business to it. In any event, if these are the vices we are trying to prevent, why aren't market forces sufficient to correct this behavior? The uncertain outcome here argues that this is a practice best regulated by market forces, aided by good disclosure practices.

The fact is that there are only two ways that a firm can make a profit from research. It can use research to make trading decisions. Or, it can sell the research to other people or firms who use it to make trading decisions. IM 2110-4 removes one of the two ways that a firm can make research pay.

The research departments of broker-dealers have a checkered past and an uncertain future. This murkiness is based in large part on the difficulty of ascertaining the value of research and paying for it. IM 2110-4 is not helpful in clarifying the murk.

Broker-dealers are fond of allocating responsibility for revenues to various departments based on their interactions with clients. Research tends to have a supporting role, which means that responsibility for its revenues has to come from departments with front-line responsibility for clients. Since revenue allocations are jealously guarded, firms have been extremely stingy in assigning research departments their just due for contributions to the bottom line. On the other hand, trading desks that actually use research to make trading decisions have a hard time arguing that research should not be assigned some of its trading profits.

Lacking a clear rationale for their existence, in the wake of the initial adoption of IM 2110-4, research departments became the handmaidens of corporate finance groups. Research reports were loaded with glowing reports for issuers that were marketing targets for investment bankers. The result has been more regulation intended to create even more Chinese Walls to deter undue influence by investment bankers on research departments.

Markets need research if they are to function efficiently. Without research, markets are much more volatile and chaotic. Research is a logical part of a broker-dealer's business. But, research departments will never function well without being able to demonstrate how their activities add to the bottom line. Ultimately, research is only useful if it is used in someone's trading decisions. There is no principled reason why research should not redound to the benefit of the broker-dealer that

spends money to create it by using it to make informed proprietary trading decisions.

Any regulation that is inconsistent with economic reality cannot succeed. IM - 2110-4 should be consigned to the scrap heap.