



December 18, 2008

Via Electronic Mail: pubcom@finra.org

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
17235 K Street, N.W.
Washington, DC 20006-1506

RE: Regulatory Notice 08-68, Circulation of Rumors (November 2008)

Dear Ms. Asquith:

Managed Funds Association (“MFA”)¹ appreciates the opportunity to respond to FINRA’s request for comment on Regulatory Notice 08-68, Circulation of Rumors (the “Notice”). MFA and its members share FINRA’s deep concerns over individuals who intentionally circulate rumors for the purpose of manipulating the market. The dissemination of false or misleading information about a company can have a significant market impact and undermine market confidence in a specific company as well as confidence in our financial markets as a whole. However, we are concerned that Proposed Rule 2030 (“Rule 2030”) would interfere with the important free flow and exchange of investment ideas that benefit the capital markets and provide transparency to investors. We are concerned that Rule 2030 would impair the ability of money managers to receive and investigate the validity of market information and have a negative impact on the overall efficiency of the marketplace.

We submit that deliberate dissemination of rumors known to be false is evidence of market manipulation, which is prohibited by sections 9 and 10 of the Securities Exchange Act of 1934 (“Exchange Act”). To more effectively prevent such market manipulation, MFA respectfully suggests that Rule 2030 should emphasize compliance with existing anti-market manipulation rules. We also believe that FINRA should require firms to adopt policies and procedures to handle rumors in a responsible fashion.

¹ MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

Proposed Rule 2030

Proposed Rule 2030 (the “Rule”) combines aspects of Incorporated NYSE Rule 435(5)² and FINRA Rule 6140(e).³ The Rule would prohibit FINRA members from originating or circulating rumors concerning any security if “the member knows or has reasonable grounds for believing [the rumor] is false or misleading or would improperly influence the market price of such security.” The Rule would also require a member to promptly report to FINRA “any circumstance which reasonably would lead the member to believe that any such rumor might have been originated or circulated.”

A. Comments

MFA appreciates FINRA’s efforts to review its approach on the circulation of rumors and its commitment to undertake a deliberative process to determine if there might be a better way to address regulatory concerns, rather than simply picking between existing rules.⁴ MFA is concerned that the Rule is overly broad and would interfere with the legitimate and beneficial flow of market information. Markets trade on the constant exchange of ideas and information. Traders learn of information everyday and are often uncertain as to its veracity and act to verify or debunk the information. Investors benefit from this information-sharing process by receiving greater information on their investments and improving the efficiency of the markets. Public companies also benefit as studies show a link between information and the cost of capital—the more information available to investors, the lower the cost of capital.⁵

Market manipulation, of course, is harmful conduct. MFA strongly condemns spreading false rumors for the purpose of manipulating securities prices. FINRA should consider the deliberate dissemination of false rumors as evidence of market manipulation, but not as a violation in and of itself. To establish a violation, FINRA should need to prove intent to manipulate market prices. We believe a rule focused on the circulation of unsubstantiated information is both overbroad and impractical, especially as the modes of communication have changed and continue to change so dramatically (*e.g.*, email, blogs, instant messenger, text messaging, social networking sites). We believe that this rule would undermine the legitimate search for information. In addition, we are concerned that the application of this rule, which

² NYSE Rule 435(5) states: No member shall circulate in any manner rumors of a sensational character which might reasonably be expected to affect market conditions on the Exchange. Discussion of unsubstantiated information published by a widely circulated public media is not prohibited when its source and unsubstantiated nature are also disclosed. Report shall be promptly made to the Exchange of any circumstance which gives reason to believe that any rumor or unsubstantiated information might have been originated or circulated for the purpose of influencing prices in listed securities.

³ FINRA Rule 6140(e) states: No member shall make any statement or circulate and disseminate any information concerning any designated security which such member knows or has reasonable grounds for believing is false or misleading or would improperly influence the market price of such security.

⁴ See Remarks by Mary L. Shapiro, CEO, FINRA, at SEC CCO Outreach BD National Seminar in Washington, D.C. on March 7, 2008.

⁵ See *e.g.*, The Benefits of Transparency, Christian Leuz, Capital Ideas, University of Chicago Booth School of Business (July 2006).

could make seemingly legitimate communications a violation, is likely to be arbitrary. A regulatory program should be built upon robust and meaningful standards—even discretionary rules should have standards.

1. Rule 2030 is overbroad.

We are concerned that Rule 2030 fails to distinguish between the legitimate circulation of unsubstantiated information (and efforts to verify such information) and the intentional circulation of false information for the purpose of manipulating the market. Rule 2030 lacks clear standards in determining a violation and is ambiguous as to the meaning of “reasonable grounds for believing” and “improperly influence the market price.” As drafted, Rule 2030 would capture activity which we believe is both legitimate and beneficial for markets. For example, please consider the following scenarios:

Example No. 1: Trader A at Firm 1 tells Trader B at Firm 2 that he has heard a rumor about a security that he believes to be untrue but he asks Trader B if he has heard the same rumor and, if so, whether he has any knowledge about its source or reliability.

Analysis: This type of information exchange and attempted verification goes on constantly in the market and is beneficial because it can provide a means of debunking or verifying information that is already circulating in the market. Nevertheless, Trader A would have violated Rule 2030 since he had reason to doubt the veracity of the rumor, “reasonable grounds for believing the rumor was false,” and communicated or “circulated” the rumor to Trader B. In this scenario, even if the rumor were true, Trader A would still be in violation of Rule 2030 since he (1) had reasonable grounds to believe the information was false and (2) circulated the information. The outcome would also remain unchanged if Traders A and B worked at the same firm.

Example No. 2: Trader C reads in *The New York Times* that Company X has issued a denial of rumors that it is in merger negotiations with Company Y. Trader C disbelieves the denial and discusses it with Trader D at another member firm.

Analysis: Trader C could arguably have violated Rule 2030, as Company X has issued an official denial, which could be deemed to provide Trader C with “reasonable grounds to believe” the rumor was false, and Trader C “circulated” the rumor by discussing it with Trader D. We note that FINRA states in the *Notice* it has deleted any exception for circulating rumors published in newspapers of general circulation. The result, as seen in this example, is that it could be a violation to discuss the news in certain circumstances.

Example No. 3: Trader E learns of information that she believes to be true—Company Z is imminently going to announce lower earnings than analysts expect. She passes along the information to another trader through instant messenger. It turns out, however, that Company Z’s earnings, as announced soon thereafter, are in line with analysts’ expectations.

Analysis: Trader E’s conduct might be viewed with the benefit of hindsight by prosecutors who might well be able to find some reason why Trader E should have doubted the veracity of the rumor and would thus charge that she had “reasonable grounds” to believe the rumor was false and circulated the rumor by passing it to another person through instant messenger. If, it turned out instead that the rumor was true, Trader E could nevertheless be

charged under Rule 2030 on the basis that, notwithstanding the truth of the rumor, Trader E had reasonable ground to have come to the erroneous belief that that rumor was false.

Example No. 4: Trader F hears that XYZ broker-dealer may be involved in a fraudulent scheme. XYZ broker-dealer publicly denies any wrongdoing. Trader F does not believe the rumor, but asks a Trader at one of XYZ's counterparties whether he has heard or can substantiate the rumor in any way.

Analysis: Trader F could arguably have violated Rule 2030 as he doubted the veracity of the rumor, "reasonable grounds for believing the rumor was false," and asked another Trader whether he had heard or could substantiate the rumor, thereby "circulating" it. Traders frequently learn of information they may not believe. However, in the interest of asset protection they have an obligation to investigate the claim. It would be impractical to expect Trader F to stop investigating the rumor merely because XYZ denied the allegation, as well as against the public interest. Rule 2030 would prohibit Trader F from investigating the rumor.

Example No. 5: Fund Manager A is concerned by the sudden price fluctuation in a security and asks Trader F at a member firm as to the cause of the market volatility. Trader G believes the price fluctuation is caused by false rumors.

Analysis: Fund managers often reach out to industry participants for information regarding a security when they see unexpected price movements in order to protect their clients' interests. Rule 2030 would prohibit Trader G from discussing the specific rumors with Fund Manager A, thereby preventing the fund manager from conducting its own due diligence. Whether a rumor is unsubstantiated, a fund manager still has a fiduciary obligation to act in the best interests of his clients. Rule 2030 would hamper such manager's ability to access important market information.

As demonstrated by the above examples, Rule 2030 prohibits or raises concerns with a number of ordinary communications that are in fact beneficial and should not be viewed as prohibited. On one hand, if FINRA brought charges in the discussed examples, the outcomes would seem unreasonable and unjust. On the other hand, if FINRA did not bring charges, it would be problematic that such discretion could be used in the application of Rule 2030 without clear standards set forth in Rule 2030 or further guidance from FINRA and it would make other applications of Rule 2030 arbitrary.

In addition, we are concerned that Rule 2030's self-reporting requirement, which turns on a reasonable belief that rumors might have been originated or circulated, is also inappropriately broad and imprecise. As drafted, Rule 2030 would likely have the effect of causing FINRA members to over-report rather than risk being second guessed with the benefit of hindsight. In each of the common examples discussed above, the receiver of information would arguably have an obligation to report to FINRA. We believe FINRA would be overburdened with reports of instances where unsubstantiated information was circulated. We are also concerned the Rule would invite abuse by parties who wish to cause problems for commercial adversaries by reporting them for spreading rumors.

2. Policies and Procedures Concerning the Circulation of Rumors

We believe a better approach to addressing the issue of rumors would be for FINRA to require member firms to adopt policies and procedures, and surveillance and training concerning the circulation of rumors. Recently, the U.K. Financial Services Authority (“FSA”) issued a comprehensive analysis and discussion on rumors (the “FSA Notice on Rumors”), which we believe FINRA should consider as it evaluates the Rule.⁶ The FSA’s Notice on Rumors provides the results of its survey of over 50 firms’ policies on rumors and recognizes that:

The flow of information, when communicated responsibly, is an essential element of efficient markets. Rumours are legitimately circulated through the financial system for a variety of reasons. It is customary for market participants to discuss rumours when accounting for the source of market volatility; when offering an objective assessment of a rumour’s likelihood to a client; and when attempting to better understand observable market behaviour. Nevertheless, rumours must be handled carefully. Their uncontrolled dissemination may lead to rapid and volatile price movements which are unjustified by market fundamentals and undermine general market confidence. Rumours can also be fabricated and spread to manipulate market prices and gain from price movements triggered by them.⁷

We believe that a robust compliance program addressing the topic of rumors would include: clear written guidelines, active training of and communication to employees regarding policies, and continued monitoring of a firm’s communications and trading. The FSA Notice on Rumors discusses best practices and common elements addressed in written policies, which include: the definition of a rumor; prohibition on creating rumors; trading based on rumors; conditions under which rumors can be communicated; form in which rumors can be communicated; and the involvement of compliance teams. For example, we suggest that where a legitimate business reason exists for a person at a firm to communicate a rumor, such person should:

- Identify the source or origin of the statement, in appropriate circumstances;
- Not provide any additional credibility or embellishment to the statement;
- Indicate that the statement is a rumor; and
- Makes clear that the person providing the information has verified the statement.⁸

The FSA Notice on Rumors also discusses best practices for training and communication of policies, monitoring of communication, monitoring of trading and interaction with compliance staff. We believe that well-trained employees are in a better position to investigate the accuracy of a rumor while minimizing the risk that any unsubstantiated information is further strengthened in its credibility. Such employee training also would contribute to the creation of more transparent and efficient markets. Finally, we believe that member firms should monitor

⁶ U.K. Financial Services Authority, Market Watch, Markets Division: Newsletter on Market Conduct and Transaction Reporting Issues (Nov. 2008) (“FSA Notice on Rumors”) *available at* http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter30.pdf.

⁷ FSA Notice on Rumors *at* p. 2.

⁸ *See id.* *at* p. 4.

communications. This should be an important component of a firm's compliance program and a strong tool to deter and detect abusive or manipulative behavior.

The FSA Notice on Rumors has much to offer to address the issue of rumors. We recommend that FINRA revise Rule 2030 to focus on compliance with existing anti-market manipulation rules, and that FINRA should require member firms to adopt policies and procedures for handling rumors, bolstered by surveillance.

B. Conclusion

MFA submits that it is not the circulation of rumors, but the dissemination of false or misleading information with the intent of manipulating the market that is harmful and undermines investor confidence in our financial markets. This type of conduct is already a violation of the securities laws. MFA is concerned that Rule 2030 is drafted overly broad and captures ordinary communications that in fact benefit the market and advance the cause of investor protection. MFA believes that a more effective method to control the spread of false or misleading information would be to require member firms to adopt policies, procedures, surveillance and training concerning the circulation of rumors. Such policies and procedures should include clear written guidelines, active training and communication of policies, and continued monitoring of communication and surveillance of trading.

We appreciate the opportunity to comment on the *Notice* and we stand ready to provide whatever additional information and comments FINRA may request. If FINRA's staff has questions or comments, please have them contact Jennifer Han or the undersigned at: (202) 367-1140.

Respectfully submitted,



Stuart J. Kaswell
Executive Vice President and General Counsel

CC: The Honorable Mary L. Schapiro, Chief Executive Officer
Mr. Marc Menchel, Executive Vice President &
General Counsel for Regulation