

National Federation of Municipal Analysts

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Paul Saltzman
Executive Vice President and General Counsel
The Bond Market Association
360 Madison Avenue
New York, N.Y. 10017

By Overnight Mail and Electronically

Reference: Comments on Exposure Draft of Guiding Principles

Dear Mr. Saltzman:

The National Federation of Municipal Analysts ("NFMA") welcomes this opportunity to comment on the Exposure Draft of Guiding Principles to Promote the Integrity of Fixed Income Research (the "Guiding Principles"). As you may know, the NFMA is an organization composed primarily of research analysts who evaluate credit and other associated risks of securities in the municipal market. Established in 1983, the NFMA has roughly 900 members who represent, among others, broker/dealers, mutual funds, rating agencies and insurance companies.

We understand that the Guiding Principles are intended to enhance investor protection by promoting greater awareness of how sell-side institutions that underwrite and trade debt securities, and distribute to investors research about those securities, can manage potential conflicts of interest. The NFMA welcomes The Bond Market Association's articulation of voluntary recommendations designed to serve as a helpful reference point for review and modification of fixed income research policies regarding fixed income research practices.

These Guiding Principles evidently grew out of the concerns surrounding the public and regulatory focus in recent years in the area of equity research. As this December 18, 2003 consensus document stated, it moved to produce recommendations to manage potential conflicts in interest with the unique characteristics of the fixed income markets in mind. As we applaud this ambitious and comprehensive effort and achievement, the NFMA notes that excesses of the equity market that this Exposure Draft attempts to address, have not been evidenced in the municipal market. Indeed, due to key structural differences the municipal market does not have the same motivation to curry favor with analysts or to protect prices of their bonds. The strictures that are applied to the equity markets cannot be readily translated to the fixed income markets, particularly municipals.

Ironically, the NFMA believes that several elements within these Guiding Principles, rather than ensure the behavioral framework that promotes reliable information flow to debt markets, including investors and issues, are likely to have the opposite effect.

National Federation of Municipal Analysts

Introduction

One of the core goals of The Bond Market Association Guiding Principles document appears to be the separation of communications between research analysts and investment bankers. The assumed benefit is that without the pressure and influence of the investment banker on an analyst to turn a balanced research report into a sales document, analysts will provide a more honest assessment of the credit attributes of the issuer in their research reports.

The NFMA believes the virtual elimination of communications between investment bankers and analysts will have serious negative consequences and is neither the only nor the best method of promoting the integrity of fixed income research. Analysts on the sell-side serve two distinct functions:

- Supporting sales and trading (desk analyst), and
- Supporting investment banking.

Support for sales and trading, particularly in the municipal arena, may involve little or no published research. Turnaround time is often short (sometimes less than an hour) and internal emails or verbal communications are the most efficient way of providing support in the time allotted.

Support for investment banking typically has a much longer time horizon (perhaps months). Analysts have traditionally provided a check and balance to the investment banker, helping determine which deals best fit the firm's risk tolerance. Analysts can be the “bad cop” with the issuer, telling the client what the market will accept, while the investment banker remains the issuer's biggest fan. Analysts focus on credit issues, educating a variety of potential and actual market participants while the banker focuses on structure. At the end of the day, the analyst's active participation in the process results in a stronger, more credit worthy offering for investors.

Published research reports are helpful to investors over time, but must be forward thinking. For example, the analyst writes on the tobacco industry not in relation to a specific trade but in anticipation of a number of future trades. In addition to being helpful to investors, however, these reports are also useful as marketing tools with issuers in that they communicate to potential investment banking clients the level of firm expertise in a given area. Doing the research necessary to write the report in fact produces the expertise that will be used in future new issue and secondary market analytical reports as well as in an investment-banking context.

Because investment banking firms understand the critical need to continue to have a credit analyst intimately involved in the investment banking process, many firms are officially separating these two functions and removing the research title from their analysts who support investment banking. In this instance the Guiding Principles have hastened along changes already made by the equity markets under the Global Settlement. As currently evolving, investment-banking departments may still be served, as needed, but these analysts will no longer be able to publish because they are no longer in the research department. As a result, investors will no longer be able to benefit from the considerable expertise of these analysts. Primary offerings will not be supported by research and secondary markets will suffer without continuing research surveillance. Many recommended practices within the Global Settlement and the Guiding Principles go beyond current regulations existing in the municipal bond market and are not viewed as having a constructive impact on this market segment and these recommended

National Federation of Municipal Analysts

practices are viewed by the NFMA as unnecessary and unnecessarily restrictive to the municipal market.

Those who prefer to work as pure desk analysts often dislike the publishing function, since that is not considered to be their optimal way in which to support the desk. If The Bond Market Association and the industry succeed in its goal of separating research analysts from investment bankers, we expect to see a decline in the amount of published research as well as deterioration in the quality of credit advice delivered to issuers. Both outcomes the NFMA considers unintended consequences of the proposed guidelines.

We believe the integrity of the Municipal Research report can be protected in other ways, as detailed in our specific comments below.

Section 4.3.2

p. 28/29

Although issuers may still check research reports for factual accuracy (Section 4.3.3), Section 4.3.2 prohibits investment-banking personnel from checking research reports for factual accuracy. This is a more restrictive prohibition than found on the equity side. While the NFMA is pleased that issuers are still allowed to review draft research reports, we believe that this restriction for investment bankers is neither practical nor desirable.

- If the report is provided to the issuer, the issuer may share it with the investment banker. Therefore, the investment banker could see the report anyway.
- The investment banker has a better understanding of some aspects of a transaction than the issuer, particularly as it relates to legal covenants and structuring. This is especially true for the bulk of municipal bond issues. On complex deals (e.g. gas prepayment contracts, tobacco securitization), NFMA has found the sharing of a written draft research report in advance of publication can assure its accuracy. In addition, sharing a draft research report can alert an investment banker to an issuer having credit difficulties. Once alerted, the banker has a vested interest in helping the issuer to overcome those problems as identified in the analyst's report. If the research report were simply released without banker review, the issuer and the buying public would be left vulnerable to a less than optimal situation.

The NFMA supports efforts to insure that such oversight is not abused. For example, the draft and final report can be shared with legal and/or compliance. Or the original draft report may be attached to the final report with all changes highlighted. Where appropriate, the supervisory analyst can review the changes at sign-off. The supervisory analyst can therefore be held liable for allowing undesirable changes in tone or conclusions. NFMA notes that all firms are not subject to a Series 16 sign-off and this should be made clear in the document. The tone or conclusions may be changed, however, if conversations with the issuer and/or investment banker result in a different understanding of the credit situation. Such is invaluable to the integrity of municipal research reports.

National Federation of Municipal Analysts

NFMA has found that issuers, particularly on the municipal front, take an analyst's questions more seriously and are willing to have a more thorough dialogue when they are confronted with a to be published report. Many of the glossed over answers turn into real answers when they read, "the issuer was unwilling to comment on..." On the other hand, failure to share the report in advance and reading that comment after the fact often closes the door more firmly for future communications. This can lead to issuers issuing in ignorance and buyers buying in ignorance. In such instances ratings, credit quality assessment of unrated deals, and/or liquidity can suffer.

Section 4.7.1

Page 36

NFMA agrees that Municipal Research analysts should not participate in any "pitches" to current or prospective clients for investment banking services business, nor have any other communications with issuers for the specific purpose of soliciting investment banking services business.

We would like the Guiding Principles, as a point of clarification, to specify that analysts may answer certain credit-related sections of an RFP. This appears to violate the "any other communication" guideline since an RFP is directly soliciting investment-banking services. Nevertheless, footnote 85 implies that an analyst may participate in the solicitation of business as long as they remain (1) objective and (2) an outsider (not party to inside information) Simultaneously, the NFMA requests a definition of inside information as it pertains to the municipal market.

An Issuer typically extends the RFP to an underwriter on the basis of the firm's past distribution performance, the NFMA requests clarification that once the final RFPs are chosen by the Issuer and final presentations are scheduled, analysts may be active participants in those presentations for educational purposes.

Page 38

Screening potential investment banking clients.

The NFMA interprets this section to mean that analysts may travel with their investment bankers to meetings with issuers (absent a formal pitch environment). The banker's goal at such meetings is generally to win the issuer as a client, unless the issuer is already a client. Therefore, all meetings can be interpreted as a solicitation of business. But it is the banker, not the analyst doing the soliciting.

One reason for bringing the analyst along is to educate a client contemplating issuance of a complex or unrated transaction. The analyst may determine that the issuer is not a desirable client for the firm (not a saleable deal or too risky for retail). It is important for the analyst to meet the client to judge the strength of management and to gain first hand knowledge of the strengths and weaknesses of a transaction before committing the firm to participating in the transaction. So, as has been suggested, why can't this happen separately on a different trip or without the banker in the room? NFMA notes that issuers may be more forthcoming and honest with the banker in the room, since they perceive the banker as an ally. When a presentation is

National Federation of Municipal Analysts

made just to analysts, such as banks when seeking a letter of credit or institutional investors on site visits, the delivery is typically scripted and can be substantially less informative. The banker always accompanies his issuer when meeting with analysts, even buy-side, bank and rating agency analysts, much like a lawyer with his client. Separate meetings are not practical. The banker wouldn't encourage the issuer to do it and the issuer wouldn't have any incentive to talk to the analysts. The ability of the sell-side analyst to gain a deeper understanding of the issuer is one of the distinguishing strengths brought to the buy-side. If the analyst and the banker are separated, the sell-side analyst doesn't have anything to offer that the buy-side can't do for themselves and therefore is an irrelevancy. The NFMA is concerned, however, that the line between "soliciting" business is not clear and that one party to the meeting (i.e. the investment banker) may in fact be soliciting business while the other (i.e. the analyst) is there for a different purpose. NFMA requests clarification on this point.

NFMA reiterates that the analyst's ability to meet with clients simultaneously with the banker prior to getting the business is essential and under the current guidelines, perfectly allowable.

Section 5.2.3

Page 59

...In the U.S., where the publication of research in advance of an offering of securities is generally prohibited by law...

We are not aware the publication of research in advance of an offering of a security is prohibited by law in the U.S. and would like the reference for this cite. We have found that firms have a variety of policies regarding the publishing blackout period before and after a sale of a fixed income security (though heretofore, not in nor rarely in municipals). On the corporate side, published research is generally permitted within the context of a regularly scheduled publication date in the normal course of business. Because corporate analysts usually publish at least quarterly on covered companies, reports are seldom stale at the time of a sale of new securities and the research analyst's opinion about the company is made available to investors.

On the municipal side, however, analysts rarely have a set of "covered" companies. Therefore, less information is available to investors, particularly on unrated deals. Some firms have tried to superimpose corporate rules for IPOs, permitting the release of a municipal research report 40 days after the pricing date. Other firms do not believe any blackout period exists for municipal issues. Some firms use 15 days before and 15 days after. The guiding principles language implies "never" before and is silent on after. This will leave the market participants without independent research on primary issues at a time when the very information is necessary to make an investment decision.

The NFMA requests guidance on the publishing blackout period for municipal transactions, both before and after a sale. Failure to clarify this issue has resulted in a reduction in information being made available to investors. Indications from the SEC are that municipal research is most needed during the time of a sale and it would not be appropriate to fail to publish at the very time independent research is needed. NFMA notes that this is particularly true for a variety of

National Federation of Municipal Analysts

municipal credits including complicated structures, story bonds, and non-rated bonds, for example.

Conclusion

Given the variety of securities and participants found within the fixed income industry, the Guiding Principles are an ambitious undertaking. No one document is likely to address all of the unique elements embodied by an industry group represented by such a wide array of debt securities and structures, corporations and regulatory bodies. Just as many of the equity regulations and current practices cannot and should not be imposed across the board in the fixed income markets, many of those same conventions and regulations cannot and should not be imposed upon the municipal market in particular. While the NFMA appreciates that the Guiding Principles are recommendations in support of a standard practice, voluntary and not intended to be an immutable set of rules, they reach well beyond the scope of existing, well performing regulations. As a consequence of this well intentioned over-reaching, as discussed above, the integrity of municipal research will be reduced rather than enhanced. In the absence of specific carve-outs for municipal research reports, analysts and investment bankers, equity market regulations and practices will be (and have already been) misapplied to the municipal market. The application of such is at best stifling and contradicts the stated goals of the Guiding Principles. This is especially true in instances where silence stands in the stead of specific guidance. In these instances, the regulations, policies and procedures of the equity markets have be superimposed on municipal market practices. In these areas the NFMA requests the Guiding Principles provide overt guidance and/or municipal market carve outs that will preserve, not impede the integrity of municipal research.

Thank you for your consideration of our comments. We would be happy to discuss this matter with you at your convenience. The NFMA looks forward to continuing to work with The Bond Market Association to promote an open, efficient and liquid municipal market.

Sincerely,

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