AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

MICHAEL A. ASARO
212.872.8100/fax: 212.872.1002
masaro@AkinGump.com

December 18, 2008

VIA EMAIL [pubcom@finra.org]

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 08-68 - Circulation of Rumors

Dear Ms. Asquith:

On behalf of Schottenfeld Group LLC ("Schottenfeld Group"), we appreciate the opportunity to provide comments to the Financial Regulatory Authority's ("FINRA") Regulatory Notice 08-68 on proposed FINRA Rule 2030 (the "Proposed Rule") regarding the circulation of rumors.

I. Introduction

Schottenfeld Group is a New York based proprietary trading firm that employs registered representatives who trade the firm's capital. Schottenfeld Group is a FINRA member firm and is registered as a broker-dealer with the U.S. Securities and Exchange Commission ("SEC"). Schottenfeld Group's registered representatives are compensated primarily through profit sharing arrangements based on their proprietary trading activities with the firm.

As explained in detail below, we believe the Proposed Rule, as currently drafted, is vague and overbroad. If adopted in its current form, it would stifle legitimate communications and necessary debate as to the value of a wide range of publicly-traded securities. Specifically, by restricting the ability of member firms and their employees to communicate both internally and externally about information that is already being circulated in the marketplace, the Proposed Rule would interfere with important efforts by securities professionals to obtain and analyze such information and react to it in a meaningful way. As a result, the Proposed Rule has the potential to artificially affect the value of securities – the very outcome that it seeks to prevent. For these reasons, we urge FINRA not to adopt the Proposed Rule or, at the very least, to modify the Proposed Rule in accordance with our comments.

II. The Conduct the Proposed Rule Purports to Address is Already Proscribed by the Federal Securities Laws and Existing FINRA Rules.

The existing regulatory framework provides sufficient tools for FINRA to address concerns about the dissemination of rumors intended to manipulate stock prices. Under existing FINRA rules, FINRA already has the general authority to bring disciplinary proceedings against any firm it determines to be spreading false rumors for the purpose of manipulating the market. Specifically, FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) prohibits a member from engaging in conduct inconsistent with just and equitable principles of trade, while FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices) prohibits members from inducing the purchase or sale of any security by means of manipulation or deception.

Moreover, spreading false rumors in order to induce others to trade in a company's securities constitutes market manipulation under the federal securities laws, which FINRA has been empowered by the SEC to enforce. Specifically, Sections 9, 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 and Section 17(a) of the Securities Act of 1933 prohibit market manipulation and false statements in connection with the purchase or sale of a security.

The Proposed Rule does not add anything to the existing regulatory framework that would assist FINRA's efforts to combat rumor-mongering. The existing rules, which have been in place for decades, provide certainty as to what constitutes a violation, because they are supported by a strong body of precedent. The Proposed Rule, on the other hand, carries with it no established precedent, and as described below, is problematic in many respects and would lead to significant uncertainty as to what conduct constitutes a violation. This uncertainty would, as a practical matter, chill the ability of traders to discuss market rumors that have already been circulated for the legitimate purpose of analyzing their veracity and developing otherwise legal trading strategies based on such analysis.

III. The Language of the Proposed Rule is Both Vague and Overbroad.

As stated above, FINRA already possesses a formidable arsenal of weapons to combat rumor-mongering. If, however, FINRA is determined to adopt a new rule tailored specifically to prohibiting the dissemination of false rumors intended to manipulate the market, the Proposed Rule is not reasonably designed to achieve its intended purpose. As drafted, the breadth and ambiguity of the Proposed Rule will create significant confusion as to exactly what sort of conduct constitutes a violation. The end result will be that firms and individuals under FINRA's regulatory umbrella have little choice other than to refrain from commenting on market rumors

altogether, despite the fact that certain FINRA officials have publicly acknowledged that this is not the desired result.[1]

A. The Intent Standard Imposed in the Proposed Rule is Vague and Highly Subjective.

The intent standard embedded in the Proposed Rule is that a member cannot originate or circulate a rumor concerning a security "which the member knows or has reasonable grounds for believing is false or misleading or would improperly influence the market price of such security." This standard is problematic and, as a practical matter, unworkable in the context of the Proposed Rule.

Determining whether market participants that are several steps removed from a rumor's source had "reasonable grounds" for believing it was false at any particular moment will be a highly subjective and unpredictable enterprise. Consider the following example: After learning of the existence of a rumor that appears to account for an otherwise unexplained movement in an issuer's stock price, a trader analyzes publicly available information and develops a thesis that the rumor is false and that the stock price will eventually experience a correction when the rumor is debunked. If the trader then discusses the rumor with other market participants, possibly for the purpose of further developing or even sharing his analysis, and his thesis later turns out to be correct, he could potentially be deemed to have violated the rule by "circulating" the rumor at a time when he had "reasonable grounds" for believing it was false. This would be a perverse result because it would actually penalize the trader for doing what a diligent, hard-working trader is supposed to do—identify market inefficiencies and profit from them. Worse yet, it would penalize the trader for engaging in discussions that could potentially correct the market's inefficiency by exposing the rumor as false.

When the SEC announced in July 2008 that it had launched a series of "examinations aimed at the prevention of the intentional spread of false information intended to manipulate securities prices," SEC Chairman Christopher Cox stated that "[t]he examinations we are undertaking with FINRA and NYSE Regulation are aimed at ensuring that investors continue to

---

[1] Nina Mehta, *FINRA: Thou Shalt Not Rumor-Monger,* TRADERSMAGAZINE.COM, Dec. 5, 2008, http://www.tradersmagazine.com/news/102743-1.html ("Referring to the circulation of rumors, [FINRA Managing Director William] Jannace said: 'To the extent it's unsubstantiated, you're giving credence to that, and you know it might not bear out, it's problematic.' However, he stressed, FINRA is 'not looking to shut off communication completely.'")

get reliable, accurate information about public companies in the marketplace."[2] However, as demonstrated above, the language of the Proposed Rule would in many cases do the opposite of what it sets out to accomplish—it will prevent traders at firms like Schottenfeld Group from engaging in legitimate attempts to obtain, analyze and confer about information that is in the marketplace and that may be moving stock prices.

One measure that would help to narrow the breadth of the standard, and better achieve the intended purpose of the rule, would be to incorporate an element of scienter similar to what exists under Rule 10b-5. Since the purpose of the Proposed Rule is to prevent members from "intentionally spreading false rumors,"[3] the inclusion of an element of fraudulent intent in the rule text would serve to narrow the proscribed conduct to only that which is *intended* to artificially affect the market. This change would alleviate the Proposed Rule's unintended effect of stifling legitimate communication among traders.

B. The Proposed Rule is Overbroad Because it Fails to Incorporate the "Sensational Character" Standard Set Forth in NYSE Rule 435(5), and it is Devoid of Any Other Form of Materiality Standard.

Not every rumor impacts a security's stock price. To the contrary, many rumors amount to nothing more than "noise" that ultimately has little or no impact on how a security trades.[4] Distinguishing between rumors that are actually material to a stock's performance from ones that are not is a tricky enterprise. Market participants therefore often engage in discussions regarding unsubstantiated information (such as rumors) in an effort to interpret the overall significance of the information learned. The breadth of the Proposed Rule as drafted would effectively prohibit traders who fall under FINRA's jurisdiction from consulting with other market participants, including securities professionals such as brokers and analysts, for assistance in determining whether a rumor is actually impacting a security's market price. This would unfairly interfere

---

[2] SEC Exchange Act Release 2008-140 (July 13, 2008), available at http://www.sec.gov/news/press/2008/2008-140.htm.

[3] *See, e.g.,* FINRA News Release (Mar. 31, 2008) (warning that "intentionally spreading false rumors or engaging in collusive activity to impact the financial condition of an issuer will not be tolerated and will be vigorously and aggressively investigated."), available at http://www.finra.org/Newsroom/NewsReleases/2008/P038211.

[4] Because many market participants are not subject to FINRA's jurisdiction, and because individuals who are intent on starting false rumors for nefarious purposes have continued to do so despite the existence of civil and criminal statutes that prohibit them from doing so, it is naïve to believe that the Proposed Rule will eliminate the proliferation of rumors completely. As such, the Proposed Rule will not eliminate the "noise;" it will just hamper the ability of brokers and traders who choose to be registered to effectively deal with it.

with a registered trader's ability to compete with other market actors not subject to the Proposed Rule.

One way to respond to this problem would be to incorporate a "materiality" requirement into the Proposed Rule. Perhaps because they recognized this exact problem, the drafters of Incorporated NYSE Rule 435(5) limited that rule's prohibition to rumors of a "sensational character." Like a materiality requirement, the "sensational character" standard provides at least some room for registered representatives to communicate with other market participants for the purpose of soliciting their views about whether a rumor explains a particular price movement in a security, or whether it can be discounted as immaterial "noise."[5]

Further, a materiality requirement would fix another harmful result of the Proposed Rule's overbreadth. The Proposed Rule, as currently drafted without a materiality element, exposes market participants to liability for circulating rumors that are substantially accurate, but which technically may contain an inaccuracy in some trivial respect. Almost every rule prohibiting false statements in civil and criminal law has such a materiality requirement, presumably for exactly this reason. Without it, the potential for such a result will chill proper communications, because rumors are, as the market knows, an imperfect source of information—there is always a danger they will contain at least some small inaccuracy.

The Proposed Rule's lack of any materiality requirement, again, further contributes to its fatal flaw. Rather than discourage the proliferation of false market-distorting rumors, the Proposed Rule prevents market participants from identifying such rumors and making informed judgments about how they should react to them. This runs contrary to the fundamental principle underlying our securities markets: the price of a security should reflect what the investing public is willing to pay after digesting all material facts about that security. The public debate about the value of a security should be robust, not hindered.

C. The Proposed Rule Should Include an Exception at Least as Broad as NYSE Rule 435(5)'s Public Media Exception.

FINRA explains that it derived certain elements of the Proposed Rule from Incorporated NYSE Rule 435(5).[6] However, the Proposed Rule eliminates NYSE Rule 435(5)'s important

---

[5] *See X & Co.*, Hearing Panel Decision 81-65, 1981 WL 90144, at *5 (N.Y.S.E. Sept. 11, 1981) (suggesting that even a takeover rumor might not be "sensational" under NYSE Rule 435(5) if it "had virtually run its course and its impact had already been felt by the marketplace.")

[6] FINRA Regulatory Notice 08-68 (Nov. 2008), at 2.

exception for "unsubstantiated information published by a widely circulated public media," provided that "its source and unsubstantiated nature are also disclosed." (the "Public Media Exception"). FINRA's only explanation for refusing to adopt this exception is that "[i]t is not clear that widely circulated rumors in the public media, that would otherwise be covered by the rule, are of less concern in terms of the market integrity concerns related to such rumors."[7] We respectfully, but vigorously, disagree.

Once a rumor has been published in the public media, any *de minimis* harm that could be caused by additional circulation is outweighed by the overriding need for licensed investment professionals to be able to communicate with each other and their clients about the existence of the rumor and their views on it.

The practical need for this type of exception is demonstrated by *X & Co.*, a NYSE Hearing Panel Decision, involving a firm charged with violating Rule 435(5).[8] In *X & Co.*, Firm X was charged with a violation of 435(5) for the internal circulation, by one of its analysts (the "Analyst"), of information respecting a well-known rumor about the stock of a company listed on the NYSE (the "Company").[9] The Analyst, who had followed the Company for a number of years, heard rumors from several sources of an impending takeover.[10] The Company's trading price began to increase significantly as a result of the rumors.[11] Consequently, the Analyst placed calls to the Company to inquire as to the truth of the rumors and was told on multiple occasions that the rumors were untrue.[12] Soon after, in a routine report to all offices of Firm X on current subjects of interest, the Analyst reported information about the takeover rumor, citing it as the reason for the increase in stock price, and disclosed that the Company had denied the rumors.[13]

The Exchange Panel held that the Analyst's conduct did not violate Rule 435(5) because "the information transmitted was not a rumor as prohibited by [Rule 435(5)] but a market fact—that a rumor indeed existed."[14] The Panel explained that a narrower reading of the rule would "seriously impair the ability of a member firm to make a helpful or beneficial comment or

---

[7] *Id.* at 3.

[8] Hearing Panel Decision 81-65, 1981 WL 90144 (N.Y.S.E. Sept. 11, 1981).

[9] *Id.* at *2-5.

[10] *Id.* at *2.

[11] *Id.* at *2, *4.

[12] *Id.* at *2.

[13] *Id.* at *3.

[14] *Id.* at *5.

communication, internally or externally, on any matter about which a rumor existed or persisted."[15]

The Panel expressed the important practical and policy reasons underlying its finding of no violation:

> The firm's internal reporting was not a negligent slip of the tongue but a deliberate, calculated transmission of information for the legitimate business purpose of preventing uninformed investors from reacting to what they mistakenly might have thought was an "inside tip" or an "exclusive". The Panel finds this conduct to be non-violative of Rule 435(5). A different interpretation of this rule, without regard for normal business practice, would unreasonably restrict the industry's research function. The present case is an example of a situation where a narrow reading of the Rule would be a detriment not only to the member firm, acting here pursuant to a legitimate business purpose, but also to the investing public.[16]

Thus, even though the analyst's conduct did not fall within the Public Media Exception (because the takeover rumor had not been "published by a widely circulated mass media"), the Panel still found that the Analyst's legitimate reporting on the well-known rumor, and its unsubstantiated nature, were so important to the investing public that they needed to be excepted from the prohibitions in the NYSE's anti-rumor rule.

We urge FINRA to include an exception to the Proposed Rule for such legitimate communications with colleagues and others about widespread rumors in the marketplace. While the Public Media Exception is certainly preferable to no exception, we believe FINRA should incorporate an exception even broader than the Public Media Exception that would exempt from violation such conduct as that described above in *X & Co.*—conduct which serves "the industry's research function."[17] Without such an exception, the Proposed Rule will prevent market participants from accurately informing clients and colleagues about material facts affecting securities and from communicating with each other to determine the veracity of questionable rumors affecting the market. The hindrance of such necessary communication must be avoided.

---

[15] *Id.* at *4.

[16] *Id.* at *5.

[17] *Id.*

D. The Proposed Rule Should Not Apply to Rumors That Are Only Circulated Internally Among a Firm's Employees.

Communication among employees of the same member firm about information in the marketplace—especially employees who are participating in investment decisions involving the same pool of capital—often serves important functions. Traders at firms like Schottenfeld Group may be following trading strategies that rely on their ability to share information, research and analysis with their colleagues. Further, for traders who are trading the same pool of capital, the ability for all traders to have access to the same information is often important to effective risk management. For this reason, we urge FINRA to include an exception to the Proposed Rule for a firm's internal communications.

E. The Reporting Requirement Imposed By the Proposed Rule is Unduly Burdensome.

We urge FINRA to either remove, or at the very least modify, the reporting requirement included in the Proposed Rule, as it is ambiguous and impractical as drafted. The reporting requirement provides that members must "promptly report to FINRA any circumstance which reasonably would lead the member to believe that any…rumor [covered by the rule] might have been originated or circulated." As explained above, a rumor covered by the Proposed Rule is one "which the member knows or has reasonable grounds for believing is false or misleading or would improperly influence the market price of such a security." This reporting requirement embedded in the Proposed Rule is problematic for a number of reasons.

First, it is unclear from the language of the rule whether a firm is required to report conduct by other member firms. Assuming, *arguendo,* that it is required to do so (since, on its face, the requirement is not limited to a firm's own conduct), this reporting requirement is far too onerous, and likely impossible for proprietary trading firms such as Schottenfeld Group. Firms such as Schottenfeld Group that focus on trading their own capital receive a large volume of unsolicited information about securities from other firms on a regular basis. In order to comply with the proposed reporting requirement, Schottenfeld Group would be forced to dedicate an entire compliance staff to policing other firms. For each piece of information received—whether solicited or not—it would be required to evaluate whether its sender reasonably believed it to be false—an impossible determination to make in most cases. Furthermore, while it is true that NYSE Rule 435(5) has had a reporting requirement for some time, proprietary trading firms with a business model similar to Schottenfeld Group are not typically NYSE members and therefore have not been subject to this requirement in the past.

Second, FINRA's use of the word "might" (members must report if they reasonably believe a violation *might* have occurred) adds additional overbreadth and confusion. Without knowing the exact source of every piece of data received from another firm, *any* information transmitted by another "might" violate the rule. Clearly the reporting requirement, as drafted, would place far too heavy of a burden on members, to the point that complete, good-faith compliance would be impossible for many firms.

For these reasons, FINRA should remove the reporting requirement altogether or, at the very least, modify it to make clear that firms are only required to report actual violations by their own registered representatives and not potential violations by other firms.

IV. The Proposed Rule Should Provide Greater Emphasis on a Firm's Policies and Procedures Regarding the Circulation of Rumors.

Currently the Proposed Rule does not place any emphasis on a firm's policies and procedures regarding the circulation of rumors. We believe FINRA should include a provision providing safe harbor for firms with adequate supervisory and compliance controls in place, which are reasonably designed to prevent the intentional creation or spreading of false information intended to affect securities prices. The inclusion of such a provision would generate powerful incentives for firms to implement such controls, and to perfect already existing polices and procedures. If a firm has adequate controls in place, and they are reasonably designed to meet the stated ends, such firm should be immunized from liability for the violations of a rogue employee under the Proposed Rule.

V. Conclusion

FINRA is already equipped under the existing regulatory framework to address concerns about rumor-mongering, and thus we believe no new rule should be adopted. If, however, FINRA is determined to adopt a new rule tailored specifically to prohibiting the dissemination of false rumors intended to manipulate the market, we urge FINRA to make the following modifications to the Proposed Rule, so as to avoid the unwanted consequences of stifling legitimate communications and necessary debate among market participants, as described above.

- The incorporation of an element of scienter similar to what exists under Rule 10b-5 would serve to narrow the proscribed conduct to only that which is *intended* to artificially affect the market.

- The incorporation of a materiality requirement would help ease the chilling effect on communication that would result from the potential for liability even for communications on trivial matters.

- The inclusion of an exception at least as broad as NYSE Rule 435(5)'s Public Media Exception would reduce the Proposed Rule's unwanted effect of preventing market participants from communicating with one another and clients about widespread rumors already affecting the market.

- The inclusion of an exception for a firm's internal communications would limit injury to internal trading strategies and risk management efforts, among other important business functions.

- Removing the reporting requirement—or, at the very least, modifying it to make clear that firms are only required to report *actual* violations by their *own* registered representatives (and not potential violations by other firms)—will alleviate the impracticability of the proposed requirement.

- The inclusion of a provision providing safe harbor for firms with adequate supervisory and compliance controls in place to prevent rumor-mongering, would generate powerful incentives for firms to implement such controls, and to perfect already existing polices and procedures.

Thank you for the opportunity to comment on Regulatory Notice 08-68. We hope the above comments are helpful in shaping FINRA's decision on whether to adopt the Proposed Rule. We would welcome the opportunity to further discuss these issues with FINRA.

Respectfully submitted,

Michael Asaro

Michael A. Asaro