

Client Alert

Current Issues Relevant to Our Clients

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SEC Seeks Comments on New FINRA Equity and Debt Research Rules

The Securities and Exchange Commission (the "SEC") is seeking comments on two new rule proposals by the Financial Industry Regulatory Authority, Inc. ("FINRA") governing equity and debt research analysts and research reports. The equity research proposal would adopt current NASD Rule 2711 with several modifications as new FINRA Rule 2241. The debt research proposal would adopt new FINRA Rule 2242 as the first FINRA rule specifically governing debt research analysts and research reports. The equity research proposal is available [here](#), and the debt research proposal is available [here](#).

Background

Current NASD Rule 2711 and Incorporated NYSE Rule 472 set forth the requirements for research analysts who publish and distribute equity research reports. The rules require disclosure of certain conflicts of interest in research reports and public appearances by research analysts and prohibit certain conduct where the conflicts are considered to be too pronounced to be cured by disclosure. In addition, current NASD Rule 1050 and Incorporated NYSE Rule 344 require any person associated with a FINRA member who functions as a research analyst to be registered as such and to pass the Series 86 and 87 exams, unless an exemption applies. There are currently no rules that deal specifically with the publication and distribution of research reports related to debt securities.

In the lead up to the recently published rule proposals, FINRA conducted a comprehensive review of all of its research rules and considered the appropriateness of adopting similar rules related to debt research reports. In March 2011, FINRA published Regulatory Notice 11-11 seeking to gather information on the differences between debt and equity research and the most appropriate rules to protect recipients of debt research. For more information about this Regulatory Notice, please see our March 18, 2011 Client Alert available [here](#). FINRA subsequently published and requested comment on two rule proposals in Regulatory Notice 12-09 and Regulatory Notice 12-42, each of which refined the previous proposal in response to comments. For more information on each of these previously proposed rules, please see our March 5, 2012 Client Alert available [here](#) and our October 17, 2012 Client Alert available [here](#). In addition, in October 2008, FINRA published Regulatory Notice 08-55 seeking comment on proposed revisions to the equity research conflicts of interest rules. That regulatory notice can be found [here](#).

New Equity Research Rules

FINRA is proposing to adopt NASD Rule 2711 as new FINRA Rule 2241 with certain modifications. The proposed rule change also would amend NASD Rule 1050 and Incorporated NYSE Rule 344 to create an exemption from the research analyst qualification requirement. The following is a summary of certain significant changes from previous rules.

Application to Advisers of Registered Investment Companies

The new rule modifies the definition of "research analyst account" to clarify that certain conflict of interest rules do not apply to a registered investment company over which the research analyst has discretion or control, provided that the research analyst or member of that research analyst's household has no financial interest in the investment company, other than a performance or a management fee. The new rule also excludes from the definition of "research report" communications concerning an open-end registered investment company that is not listed or traded on an exchange, as FINRA believes that the existing regulatory framework and content standards for these types of communications and the pricing of fund shares at NAV substantially diminish the likelihood of manipulation of the price of mutual fund securities.

Identifying and Managing Conflicts of Interest

The new rule requires members to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to (1) the preparation, content and distribution of research reports, (2) public appearances by research analysts and (3) the interaction between research analysts and persons outside of the research department, including investment banking and sales and

trading personnel, the subject companies and customers. The rule goes on to set out detailed minimum requirements for these written policies and procedures. While the new rule offers some flexibility to members to manage identified conflicts, some types of conflicts are prohibited outright as disclosure of such conflicts is deemed to be an inadequate mitigation.

Joint Due Diligence and Other Interaction with Investment Banking

The proposed rule includes a new prohibition on joint due diligence conducted by research analysts in the presence of investment banking personnel prior to the selection by the subject company of underwriters for its investment banking services. In addition, the proposed rule continues the prohibition on investment banking department personnel from directing a research analyst to engage in certain sales or marketing efforts, and clarifies that three-way meetings between research analysts and current or prospective customers in the presence of investment banking department personnel or company management about an investment banking services transaction are prohibited by this provision.

Promises of Favorable Research and Prepublication Review by a Subject Company

The proposed rule expands on the current prohibition against promises of favorable research by prohibiting prepublication review of a research report by a subject company for purposes other than verification of facts. The proposed Supplementary Material maintains the current guidance applicable to the prepublication submission of a research report to a subject company.

Personal Trading Restrictions

Current NASD Rule 2711 imposes outright prohibitions under certain circumstances and time periods on research analysts trading in securities of companies that the research analyst covers. The proposed rule instead requires that firms establish policies and procedures that restrict or limit research analyst account trading in securities, any derivatives of such securities and funds whose performance is materially dependant upon the performance of securities covered by the research analyst. The rule proposal states that it is FINRA's intention to offer firms more flexibility in adopting a supervisory approach.

Content and Disclosure in Research Reports

The proposed rule maintains the existing research report disclosure requirements with certain modifications. The proposed rule change adds a requirement that a member must establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in its research reports are based on reliable information. In addition, the proposed rules require disclosure of a variety of conflicts of interests a research

analyst may have in one or more of the companies that is the subject of a research report that is known by any associated person of the member with the ability to influence the content of the research report. The proposed rule also modifies the current requirement to disclose when a member or its affiliates own securities of the subject company to include any significant financial interest in the debt or equity of the subject company, including, at a minimum, beneficial ownership of 1% or more of any class of common equity securities of the subject company.

Disclosures in Public Appearances

The proposed rule maintains similar substantive disclosure requirements for public appearances as the current rule with one exception. The proposed rule also requires that research analysts disclose in any public appearance if a member or its affiliates maintain a significant financial interest in the debt or equity of the subject company, including, at a minimum, beneficial ownership of 1% or more of any class of common equity securities of the subject company. While similar to the research report disclosure discussed above, this disclosure requirement in public appearances applies only to a conflict of interest that the research analyst knows of or has reason to know at the time of the public appearance and does not extend to conflicts that an associated person with the ability to influence the content of a research report or public appearance knows or has reason to know.

Distribution of Member Research Reports

The rule proposal incorporates and expands on existing guidance related to current FINRA Rule 2010 by requiring member firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that a research report is not distributed selectively to internal trading personnel or a particular customer or class of customers in advance of other customers that the firm has previously determined are entitled to receive the research report. The new guidance clarifies that firms may provide different research products and services to different classes of customers, provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm discloses its research dissemination practices to all customers that receive a research product.

Distribution of Third-Party Research Reports

The rule proposal generally maintains the existing third-party disclosure requirements, with one modification. The proposed rule would require a member to disclose if the member or its affiliates maintain a significant financial interest in the debt or equity securities of the subject company, including, at a minimum, if the member or its affiliates beneficially own 1% or more of any class of securities of the subject company. The new rule would also require disclosure of any material conflicts of interest

that can reasonably be expected to have influenced the member's choice of research report or third-party research provider.

Exemption from Registration Requirements for Certain "Research Analysts"

The proposed rule provides for a limited exemption from the definition of "research analyst" for those persons who only occasionally produce research reports. The revised definition of research analyst is limited to those persons who produce research reports and whose primary job function is to provide investment research. A person meeting such definition would be required to register as a research analyst with FINRA. While the proposed FINRA rules would still apply to the production and distribution of research reports, persons who only occasionally produce research reports or whose primary job responsibility is not to provide investment research would not be required to register as research analysts.

New Debt Research Rule

The proposed debt research rule adopts a substantial portion of the equity research rules and their basic framework for debt research distributed to retail investors, with modifications to reflect the different nature and trading of debt securities. The proposed debt research rule differs from the proposed equity research rule in three primary ways. First, the proposed debt research rule would delineate the prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel. Second, the proposed debt research rule would exempt debt research provided solely to institutional investors from many structural protections and prescriptive disclosure requirements that apply to research reports distributed to retail investors. Third, similar to the proposed equity research rule, the proposed debt research rule adopts an exemption from certain requirements of the rule for certain firms with only limited investment banking activities, but builds upon the proposed equity research rules by providing for a similar exemption for firms with limited principal trading activity. The following summary discusses the definition of "debt research report" and then highlights these three primary differences in the proposed debt research rule as compared to the proposed equity research rule described above.

Definition of "Debt Research Report"

The proposed rule defines the term "debt research report" as any written communication that includes an analysis of a debt security or an issuer of a debt security and that provides information reasonably sufficient upon which to base an investment decision, excluding communications that solely constitute an equity research report as defined in proposed Rule 2241(a)(11). Communications that constitute statutory prospectuses that are filed as part of the registration statement would not be included in the

definition of a debt research report. In general, a debt research report would not include any of the following communications, so long as they do not include an analysis of, or recommend or rate, individual debt securities or issuers:

- Discussions of broad-based indices;
- Commentaries on economic, political or market conditions;
- Commentaries on or analyses of particular types of debt securities or characteristics of debt securities;
- Technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price;
- Recommendations regarding increasing or decreasing holdings in particular industries or sectors or types of debt securities; or
- Notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent debt research report on the subject company that includes all current applicable disclosures required by the rule and that such debt research report does not contain materially misleading disclosure, including disclosures that are outdated or no longer applicable.

The term debt research report would also generally not include the following communications, even if they include an analysis of an individual debt security or issuer and information reasonably sufficient upon which to base an investment decision:

- Statistical summaries of multiple companies' financial data, including listings of current ratings that do not include an analysis of individual companies' data;
- An analysis prepared for a specific person or a limited group of fewer than 15 persons;
- Periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual debt securities in the context of a fund's or account's past performance or the basis for previously made discretionary investment decisions; or
- Internal communications that are not given to current or prospective customers.

Communications Between Debt Research Analysts and Trading Personnel

The proposed rule delineates the prohibited and permissible interactions between debt research analysts and sales and trading and principal trading personnel. In the rule proposal, FINRA acknowledged that certain

communications between debt research analysts and trading desk personnel are essential to the discharge of their functions. Accordingly, the proposed rule would permit sales and trading and principal trading personnel to communicate customers' interests to a debt research analyst, so long as the debt research analyst does not respond by publishing debt research for the purpose of benefiting the trading position of the firm, a customer or a class of customers. In addition, debt research analysts may provide customized analysis, recommendations or trade ideas to sales and trading and principal trading personnel and customers, provided that any such communications are not inconsistent with the analyst's currently published or pending debt research, and that any subsequently published debt research is not for the purpose of benefiting the trading position of the firm, a customer or a class of customers.

Exemption for Debt Research Reports Provided to Institutional Investors

Recognizing the differences in how institutional investors interact with broker-dealers of debt securities and equity securities, the proposed rule would exempt debt research distributed solely to eligible institutional investors from most of the provisions regarding supervision, coverage determinations, budget and compensation determinations and all of the disclosure requirements applicable to debt research reports distributed to retail investors. Research reports distributed pursuant to this exemption must contain general disclosures displayed prominently on the first page warning, among other things, that the report is only intended for institutional investors and lacks the standard disclosure of retail research reports. Under the proposed rule, institutional investors may still opt-in to receiving research reports that are subject to the full protections of the rule. Notwithstanding the proposed exemption, some provisions of the proposed rule would still apply to research reports distributed to any institutional investors, including the prepublication review of debt research reports by investment banking personnel and the restrictions on such review by subject companies.

Exemption for Members with Limited Investment Banking and Limited Principal Trading Activity

Similar to the equity research rules, the proposed rule exempts from certain provisions regarding supervision and compensation of debt research analysts those members that over the previous three years, on average per year, have participated in ten or fewer investment banking services transactions as a manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions. The proposed debt rule expands upon the proposed equity rule by providing an exemption from some provisions of the proposed rule that require separation of debt research from sales and trading and principal trading for firms that engage in limited principal trading activity where (1) in absolute value on an annual basis, the member's trading gains or losses on

principal trades in debt securities are \$15 million or less over the previous three years, on average per year, and (2) the member employs fewer than 10 debt traders; provided, however, such members must establish information barriers or other institutional safeguards to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to all of the requirements of proposed FINRA Rule 2242(b).

Submitting Comments and Next Steps

You can submit comments to the SEC by submitting a hard copy, by using the SEC's internet comment form link available under SR-FINRA-2014-047 for the equity research rules or SR-FINRA-2014-048 for the debt research rules at this [link](#), or by sending an e-mail to rule-comments@sec.gov with File Number SR-FINRA-2014-047 for the equity research rules or File Number SR-FINRA-2014-048 for the debt research rule in the subject line. Comments on both rules must be submitted on or before December 15, 2014. FINRA will announce the effective date of the rules no later than 60 days following SEC approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing SEC approval.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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