

## FINRA Proposes Revised Debt Security Research Rule

The Financial Industry Regulatory Authority, Inc. (“FINRA”) recently issued a revised rule proposal to address debt research conflicts of interest. FINRA originally published a concept proposal on debt research in March 2011 followed by a formal rule proposal in February 2012. FINRA now seeks comment on a revised rule proposal that includes amended exemptions for research distributed to certain institutional investors and for firms with limited principal debt trading activity. The revised proposal also includes other changes in response to comments on the prior proposal.

The FINRA Regulatory Notice proposing the new rule changes is available at: <http://www.finra.org/Industry/Regulation/Notices/2012/P187304>.

For information on the original rule proposal, please see our March 2012 Client Alert available at: <http://www.chapman.com/media/news/media.1162.pdf>.

For information on the original concept proposal and background for the rule proposal, please see our March 2011 Client Alert available at: <http://www.chapman.com/media/news/media.977.pdf>.

### Background

In its February 2012 rule proposal, FINRA requested comment on a proposal to address debt research conflicts of interest which would provide retail customers with generally the same protections provided to recipients of equity research, while exempting debt research distributed exclusively to eligible institutional investors. Eligible institutional investors would have been required to affirmatively notify a member firm in writing if they wished to receive institutional debt research and forego the protections provided to retail customers. The proposal also would have exempted broker-dealers that engage in limited investment banking activity. In response to comments received and other data and industry feedback, FINRA has now revised the proposed exemptions and seeks comment on their scope and content. FINRA also seeks cost/benefit data related to the appropriateness of the revised exemptions and any alternatives.

### Changes to Institutional Debt Research Exemption

The original rule proposal included an exemption for debt research reports disseminated only to institutional investors. The exemption would have required that each recipient institutional investor affirmatively notify the member firm publishing the research report that the institutional investor wished to forego treatment as a retail investor for the purposes of the rule. FINRA received several comments on this condition suggesting that it was unnecessarily burdensome and may exclude a significant number of investors. In response, FINRA now proposes a “higher tier” of institutional investors that could receive institutional debt research without written agreement. Under the revised proposal, broker-dealers could obtain agreement by negative consent if the institutional investor chose not to notify the firm it wishes to be treated as a retail investor. This higher tier exemption would be available to an institutional investor that:

- meets the definition of “qualified institutional buyer” (“QIB”) under Rule 144A under the Securities Act of 1933; and
- satisfies the following new FINRA Rule 2111 institutional suitability standards: (a) the member firm publishing the research report has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently (in general and with regard to particular transactions and investment strategies involving a “debt security” or “debt securities,” as defined in the proposed rule); and

(b) the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the firm's recommendations pursuant to the suitability rule, provided such affirmation covers transactions in debt securities.

Under the revised proposal, a member firm could still rely on the exemption with respect to certain other institutional investors that do not meet these higher tier requirements provided that each such institutional investor, prior to receipt of a debt research report, has affirmatively notified the member in writing that it wishes to receive institutional debt research and forego treatment as a retail investor for the purposes of the rule. FINRA seeks comment on this proposed approach, particularly with respect to firms' use of existing compliance procedures and systems to identify persons meeting the higher tier requirements or whether an alternative standard would be more appropriate from a cost/benefit perspective while offering similar protections.

### Exemption for Firms with Limited Principal Debt Trading

The revised proposal includes a new exemption for firms with limited principal debt trading activity. This exemption would apply to firms that have:

- gains or losses of less than \$15 million from principal debt trading activity on average over the previous three years; and
- fewer than 10 debt traders.

Firms that meet the criteria would be exempt from separating debt research analysts and those engaged in sales and trading and principal trading activities with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination. For purposes of the exemption, a debt trader would be defined as a person who, with respect to debt securities transactions, is engaged in proprietary trading or the execution of transactions on an agency basis. Firms would be required to document the basis for such eligibility and maintain records of applicable communications for at least three years.

FINRA seeks comment on this proposed exemption, particularly with respect to whether the \$15 million and 10 debt traders thresholds are appropriate, whether gains and losses (in absolute value) from principal debt trading and number of debt traders are appropriate criteria, and

what the advantages and disadvantages of this proposal are or whether an alternative would be more appropriate.

### Limited Investment Banking Exemption

The revised proposal maintains the earlier-proposed exemption of members with limited investment banking activity from certain provisions of the rule. The exemption would be available to firms that over the previous three years participated in 10 or fewer investment banking services transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions. This is the same metric used for an exemption from certain provisions of the equity research rules. FINRA notes that data suggest that incremental increases to these thresholds would not result in a significant number of additional firms eligible for the exemption, but seeks comment on whether the criteria and thresholds are appropriate or whether alternatives would provide greater advantages. In particular, FINRA seeks quantification, where possible, on the impact of competition among firms and to what extent investors might be harmed by receiving unreliable conflicted research.

### Other Changes

In response to comments received, the revised proposal makes certain other changes to the earlier proposal, including:

- *Debt Research Report*—The definition of “debt research report” would conform to the Securities and Exchange Commission’s Regulation Analyst Certification definition and clarify that the definition covers an analysis of either a debt security or an issuer and excludes reports on types or characteristics of debt securities. The proposed rule would also list all of the exceptions to the definition.
- *Disclosure of Comments*—The revised proposal would require disclosure of material conflicts that are known or should have been known by the member firm or debt analyst at the time of publication or distribution of the report. This standard replaces the requirement in the previous proposal to disclose all conflicts that reasonably could be expected to influence the objectivity of the debt research report.
- *Compensation Disclosure for Foreign Sovereign Debt*—In lieu of disclosing investment banking

compensation received by a non-U.S. affiliate from foreign sovereigns, the revised proposal would permit firms to implement information barriers between that affiliate and the debt research department to prevent direct or indirect receipt of such information. However, disclosure would still be required if the debt analyst has actual knowledge of receipt of investment banking compensation by the non-U.S. affiliate.

- *Road Show Prohibition*—The revised proposal clarifies that the earlier-proposed prohibition on road shows would apply only with respect to road shows and other marketing activities on behalf of an issuer related to an investment banking services transaction.
- *Prohibition on Joint Due Diligence*—The revised proposal deletes the earlier-proposed provision that would prohibit joint due diligence by debt research analysts and investment banking personnel, conforming to the equity research rules.

- *Valuation Method Disclosure*—The revised proposal would require explanation of “valuation method used” only where a specific valuation method has been employed.
- *Research Analyst Interactions with Sales and Trading*—The revised proposal would clarify that, in determining what is inconsistent with an analyst’s published research, firms may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the analyst’s published views.

You may submit comments on the proposal to FINRA through December 10, 2012 by hard copy or by emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org).

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at [chapman.com](http://chapman.com).

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