

# Client Alert

Current Issues Relevant to Our Clients

September 2, 2015

## FINRA Adopts New Equity and Debt Research Rules

*The Financial Industry Regulatory Authority, Inc. (“FINRA”) recently announced the adoption of amendments to its equity research rules and entirely new rules governing debt research. The equity research amendments adopt current NASD Rule 2711 as new FINRA Rule 2241 with several modifications and also include amendments to NASD Rule 1050 and Incorporated NYSE Rule 344 to create an exception from the research analyst qualification requirement. The new debt research rule, FINRA Rule 2242, will be the first FINRA rule specifically governing debt research analysts and research reports. Minor changes were made to the original proposals following the public comment period. For more information about the original proposals, please see our December 2, 2014 Client Alert available [here](#). The Regulatory Notice regarding the equity research rules is available [here](#), and the Regulatory Notice regarding the debt research rules is available [here](#). The new equity research rule has effective dates of either September 25, 2015 or December 24, 2015, depending on the provisions, and the new debt research rule has an effective date of February 22, 2016.*

### 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 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 adoption of these new and amended rules, FINRA conducted a comprehensive review of all of its research rules and considered the appropriateness of adopting similar rules related to debt research reports. The adoption of the new and amended rules began in 2011 with a FINRA concept proposal to apply requirements to debt security research reports and culminated with the recent Securities and Exchange Commission (the “SEC”) approval of the new and amended rules. For more information about the SEC orders approving the rules, please see our July 27, 2015 Client Alert available [here](#).

### New Equity Research Rules

FINRA is adopting NASD Rule 2711 as new FINRA Rule 2241 with certain modifications. FINRA is also amending 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.

#### Identifying and Managing Conflicts of Interest

Rule 2241 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 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

Rule 2241 includes a new prohibition on joint due diligence conducted on a company by research analysts in the presence of investment banking personnel prior to the

selection of underwriters for investment banking services by the subject company. In addition, the new rule continues to prohibit investment banking personnel from directing a research analyst to engage in certain sales or marketing efforts. The rule also clarifies that three-way meetings between research analysts and current or prospective customers in the presence of investment banking personnel or company management about an investment banking transaction are prohibited by the rule. The new rule also requires members to adopt written policies and procedures to establish information barriers or other safeguards reasonably designed to ensure research analysts are insulated from the review, pressure or oversight by investment banking personnel or others who might be biased in their judgment or supervision.

#### **Prepublication Review by Non-Research Personnel**

Rule 2241 requires members to adopt written policies and procedures to prohibit prepublication review, clearance or approval of research reports by investment banking personnel or certain other non-research personnel (other than legal and compliance personnel). This effectively eliminates the exception under existing rules that allows for prepublication review by investment banking personnel for factual accuracy and conflicts. In addition, the new rule prohibits prepublication review of a research report by a subject company for purposes other than verification of facts.

#### **Promises of Favorable Research and Prepublication Review by a Subject Company**

Rule 2241 maintains the current prohibition on promises of favorable research and requires written policies and procedures to prohibit explicit or implicit promises of favorable research, a particular research rating or recommendation or specific research content as inducement for the receipt of business compensation.

#### **Personal Trading Restrictions**

Current NASD Rule 2711 imposes outright prohibitions under certain circumstances and time periods on a research analyst trading in securities of companies that the research analyst covers. New Rule 2241 instead requires that firms establish policies and procedures that restrict or limit research analyst 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. This should offer firms more flexibility in adopting a supervisory approach.

#### **Content and Disclosure in Research Reports**

Rule 2241 maintains the existing research report disclosure requirements with certain modifications. The new rule 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 and that any recommendation, rating or price target has a reasonable basis and be accompanied by a clear explanation of any valuation method used. In addition, the new rule requires disclosure of a variety of conflicts of interests a research analyst may have in the companies that are 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 report. The new rule also modifies the current requirement to disclose when a member or its affiliates own securities of a company to include any significant financial interest in the debt or equity of the company, including, at a minimum, beneficial ownership of 1% or more of any class of common stock of the company.

#### **Disclosures in Public Appearances**

Rule 2241 maintains similar substantive disclosure requirements for public appearances as the current rule with one exception. The new 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 a company, including, at a minimum, beneficial ownership of 1% or more of any class of common stock of the 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 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**

Rule 2241 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**

Rule 2241 generally maintains the existing third-party disclosure requirements, with one modification. The new rule requires a member to disclose if the member or its affiliates maintain a significant financial interest in the debt or equity securities of a company, including, at a minimum,

if the member of its affiliates beneficially own 1% or more of any class of common stock of the 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 for Firms With Limited Investment Banking Activity**

Similar to the current rule, Rule 2241 maintains the exemption for firms with limited investment banking activity from the prohibition on research analyst supervision or control by investment banking personnel. The exemption is available for 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. Rule 2241 expands on the current rule's exemption by extending the exemption to the provisions requiring research analyst compensation to be determined by a compensation committee and to the provisions restricting or limiting research coverage decisions and budget determinations. The rule also requires that members relying on this exemption establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from pressure by persons engaged in investment banking activities.

### **Exemption from Registration Requirements for Certain "Research Analysts"**

In addition to the new equity research rule, FINRA is creating a new limited exemption from the research registration and qualification requirements for those persons who only occasionally produce research reports by amending the definition of "research analyst" in NASD Rule 1050(b) and Incorporated NYSE Rule 344.10. 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 Rule 2241 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.

### **Quiet Periods**

The new rule modifies the required quiet periods after an initial public offering or secondary offering. The quiet period applicable to initial public offerings has been reduced from a maximum of 40 days to 10 days after the completion of an offering, and the quiet period applicable to secondary offerings has been reduced from 10 days to three days after the completion of an offering. The new

rule also eliminates the quiet period associated with the expiration, waiver or termination of lock-up agreements. The required quiet periods under the new rule do not apply to offerings of "Emerging Growth Company" securities (as defined in the Securities Exchange Act of 1934).

### **New Debt Research Rule**

The new debt research rule, FINRA Rule 2242, adopts a substantial portion of the equity research rule and its basic framework for debt research distributed to retail investors, with modifications to reflect the different nature and trading of debt securities. For this purpose, "debt security" excludes municipal securities and U.S. Treasury securities. The new debt research rule differs from the equity research rule in three primary ways. First, the debt research rule delineates the prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel. Second, the debt research rule exempts 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 equity research rule, the debt research rule adopts an exemption from certain requirements of the rule for certain firms with only limited investment banking activities, but also provides a similar exemption for firms with limited principal trading activity. Rule 2232 also draws a distinction between "sales and trading personnel" and persons engaged in principal trading activities ("principal trading personnel"), imposing greater restrictions on the latter. "Sales and trading personnel" includes persons in any department or division, whether or not identified as such, who perform any sales or trading service on behalf of a member. The following summary discusses the definition of "debt research report" and then highlights these three primary differences in the debt research rule as compared to the equity research rule described above.

#### **Definition of "Debt Research Report"**

The new rule defines "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. The term also excludes a communication that solely constitutes an equity research report as defined in new Rule 2241. Communications that constitute statutory prospectuses that are filed as part of the registration statement or private placement memoranda 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 readers 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**

New Rule 2242 delineates the prohibited and permissible interactions between debt research analysts and sales and trading and principal trading personnel. FINRA acknowledges that certain communications between debt research analysts and trading desk personnel are essential to the discharge of their functions. Accordingly, the new rule permits 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 Rule 2242 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 new rule, institutional investors may still opt-in to receiving research reports that are subject to the full protections of the rule. Notwithstanding this exemption, some provisions of the new rule still apply to research reports distributed to 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 or Limited Principal Trading Activity**

Similar to the equity research rule, Rule 2242 includes certain exemptions for 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 new debt rule provides an exemption from some provisions of the debt 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.

### **What Now?**

Most of the provisions of the new equity research rule will become effective on December 24, 2015, with certain provisions, including the new provisions related to the



registration of research analysts, becoming effective earlier on September 25, 2015. The new debt research rule will become effective in its entirety on February 22, 2016. Member firms should review their existing policies and procedures in light of these new rules.

## For More Information

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*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](http://chapman.com).*

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