Chapman and Cutler LLP

Chapman Client Alert

April 21, 2017 Current Issues Relevant to Our Clients

FINRA Proposes Safe Harbor for "Desk Commentary" from Research Rule Requirements

FINRA recently requested comments on proposed amendments to FINRA Rule 2241 (on equity research) and FINRA Rule 2242 (on debt research) that would create a safe harbor for trading desk commentary distributed to eligible institutional investors subject certain conditions. The FINRA proposal is available here. For more information on the rules, see our prior Client Alerts available here, here, here and here.

Background

The equity research rule first went into effect in 2015 and the debt research rule had an initial compliance date of July 16, 2016. Certain trading desk commentary directed to institutional investors could be considered a "research report" or "debt research" under these rules and have created uncertainty for many firms and their compliance departments. FINRA notes that this type of desk commentary tends to be brief, focused on the near term, and prepared and disseminated quickly in response to trading events or news flashes. FINRA also notes that the institutional investors who receive this type of information value the timely receipt of the information but are capable of exercising independent judgment in evaluating recommendations and reaching investment decisions. However, FINRA has also observed desk commentary that amounts to fundamental research that is intended to fall within the definitions and restrictions of the research rules. FINRA is proposing a safe harbor for desk commentary to provide firms with more compliance certainty in their review of research communications subject to a number of requirements and conditions.

The Proposed Safe Harbor

The proposed amendments would provide a non-exclusive safe harbor for eligible desk commentary from certain research rule provisions. However, certain conditions for reliance on the safe harbor include compliance with conditions included in the equity research rule or debt research rule.

What is "Desk Commentary" under the Proposed Safe Harbor?

The proposed safe harbor would only be available for communications meeting certain conditions. Desk commentary eligible for the proposed safe harbor would be limited to commentary produced by sales and trading and principal trading personnel who:

- are not primarily engaged in the preparation of research reports that do not meet the safe harbor content limitation;
- do not require registration as a research analyst pursuant to NASD Rule 1050 because their primary job function is something other than to provide investment research; and
- do not report directly or indirectly to research department personnel.

In order to qualify as desk commentary reports would be required to be limited to brief observations (not including a rating, price target or earnings estimate) regarding recent, current or near term expected trading activity, trading ideas or opportunities, market conditions, economic statistics or company results, or regarding a recent recommendation or research report.

Who could receive "Desk Commentary" under the Proposed Safe Harbor?

To qualify for the proposed safe harbor, commentary could be distributed solely to consenting investors that meet the definition of "institutional account" under FINRA Rule 4512(c) and have satisfied the FINRA Rule 2111 institutional suitability standard with respect to equity or debt transactions or trading strategies as applicable. This would require firms to obtain consents from institutional investors which could be achieved by negative consent. FINRA would provide firms with a transition period during which desk commentary eligible for the proposed safe harbor could be sent to eligible investors while firms obtain necessary consents.

Conflict Management Requirements

The proposed safe harbor under the research rules would require compliance with several provisions of those rules to mitigate the most serious research-related conflicts that can be present with desk commentary. The proposed safe harbor would require firms to establish, maintain and enforce written policies and procedures meeting a number of specific conditions focused on preventing current or potential investment banking activities of a firm from compromising the objectivity of personnel engaged in producing desk commentary. The proposed amendments would also require firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that desk commentary subject to the proposed safe harbor is made available only to eligible investors and that firms could not rely on the proposed safe harbor with respect to desk commentary that the firm has reason to believe would be redistributed to a retail investor. The proposed safe harbor would relieve a firm of its obligations to comply with the anti-fraud provisions of the federal securities laws and FINRA rules. The proposed safe harbor would also not impact a firm's obligation to establish, maintain and enforce written procedures reasonably designed to prevent the dissemination of material non-public research information.

Required Disclosures

The proposed safe harbor would require desk commentary to carry a "health warning" similar to what is required by the institutional debt research exemption in the debt research rule. The health warning would be required to state:

- "This document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to research reports prepared for retail investors"; and
- if applicable "Clients should assume this document is not independent of [Firm's] proprietary interest. [Firm] trades, and will continue to trade, the securities covered in this document for its own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to or entered into in advance of this document."

Additional Requirements for Equity Desk Commentary Safe Harbor

The proposed safe harbor for equity desk commentary would require compliance with additional provisions of the equity research rule to mitigate against the influences of investment banking conflicts.

Potential Relief Provided by the Safe Harbor

Compliance with the proposed safe harbor conditions would relieve a firm that produces and distributes desk commentary from compliance with several of the rules' conflict management provisions and the specific disclosure requirements. The proposed safe harbor would also relieve covered desk commentary author from the registration and qualification requirements for equity research analysts. To the extent desk commentary authors would not be subject to registration, the proposal would also exempt associated persons who review equity desk commentary from the requirement.

While the proposed safe harbor under the debt research rule is similar to the current Rule 2242(j) institutional debt research exception, the proposal would still retain that exception. The institutional debt research exemption could be applied to all debt research reports meeting those conditions and would require a slightly different health warning. However, the current institutional debt research exemption requires affirmative consent for receipt of the research reports for smaller institutions whereas the proposed safe harbor would allow for negative consent as the institutional debt research exemption does for larger institutions. Determining whether to rely on the proposed safe harbor or the existing institutional debt research exception would depend on the content of the piece, authors and potential audience.

What's Next?

You can submit comments on the proposal to FINRA by email to pubcom@finra.org or by mail through May 30, 2017. Prior to the amendments becoming effective, FINRA would need to complete the comment process, have the proposal approved for filing with the Securities and Exchange Commission ("*SEC*") by the FINRA Board of Governors and complete the filing and notice process with the SEC.

For More Information

If you would like 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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