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## Securities Alert

### A Bold New Regulatory Landscape for Research: SEC Approves FINRA Rules Addressing Conflicts of Interest for Equity and Debt Research

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More than ten years after the Global Research Settlement and the adoption of NASD Rule 2711, the Securities and Exchange Commission (SEC or Commission) has approved new FINRA rules addressing conflicts of interest for both equity and debt research analysts and research reports.<sup>1</sup> The new rules, FINRA Rules 2241 and 2242 (collectively, the Research Rules or Rules), will require FINRA member firms to establish certain policies and procedures related to equity (Rule 2241) and debt (Rule 2242) research reports and research analysts.<sup>2</sup> The Research Rules are the product of a lengthy and dynamic rulemaking process, which began in 2008 and involved multiple rule proposals, several opportunities for public comment, and many amendments.<sup>3</sup> They are intended to address conflicts of interest relating to the publication and distribution of equity and debt research reports and research analysts, and to foster objective and transparent research.

Although the Research Rules are modeled after NASD Rule 2711 and NYSE Rule 472 (which currently apply to equity research), they will significantly expand firms' obligations to identify and manage research-related conflicts and impose several new requirements and restrictions on research-related activity. On the equity side, FINRA Rule 2241 also incorporates recommendations from a joint report issued by FINRA and the NYSE in 2005 regarding the operation and effectiveness of the research analyst conflict of

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<sup>1</sup> Order Approving a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, To Adopt FINRA Rule 2241 (Research Analysts and Research Reports) in the Consolidated FINRA Rulebook, Release No. 34-75471, 80 Fed. Reg. 43482 (July 22, 2015) ("Equity Adopting Release"); Order Approving a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, To Adopt FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports), Release No. 34-75472, 80 Fed. Reg. 43528 (July 22, 2015) ("Debt Adopting Release"). The Global Research Settlement refers to the 2003 settlement that federal and state authorities and self-regulatory organizations reached with 10 broker-dealers to resolve allegations of misconduct involving conflicts of interest between their research analysts and investment bankers. In 2004, two additional firms settled substantively under the same terms, which included provisions to effectively separate research from investment banking. NASD Rule 2711 and NYSE Rule 472, which currently govern equity research conflicts, were adopted in the midst of the investigations that led to the Global Research Settlement.

<sup>2</sup> The SEC also approved the amendment of NASD Rule 1050 (Registration of Research Analysts) and incorporated NYSE Rule 344 (Research Analysts and Supervisory Analysts) to create an exception from the research analyst qualification requirements. NASD Rule 1050 and NYSE Rule 344 require any person associated with a member and who functions as a research analyst to be registered as such and pass the Series 86 and 87 exams, unless an exemption applies. NASD Rule 1050 defines "research analyst" as "an associated person who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report." Incorporated NYSE Rule 344 has a substantially similar definition.

<sup>3</sup> See FINRA Regulatory Notice 08-55, Research Analysts and Research Reports—FINRA Requests Comment on Proposed Research Registration and Conflict of Interest Rules (Oct. 2008) ("Reg Notice 08-55"); FINRA Regulatory Notice 11-11, FINRA Requests Comment on Concept Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports (Mar. 2011); FINRA Regulatory Notice 12-09, FINRA Requests Comment on a Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports (Feb. 2012); FINRA Regulatory Notice 12-42, FINRA Requests Comment on a Revised Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports (Oct. 2012); Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2241 (Research Analysts and Research Reports) in the Consolidated FINRA Rulebook, Release No. 34-73622, 79 Fed. Reg. 69939 (Nov. 24, 2014) ("Initial Equity Rule Filing"); Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports), Release No. 34-73623, 79 Fed. Reg. 69905 (Nov. 24, 2014) ("Initial Debt Rule Filing"); Notice of Filing of Amendment No. 1 to a Proposed Rule Change to Adopt FINRA Rule 2241 (Research Analysts and Research Reports) in the Consolidated FINRA Rulebook, Release No. 34-74488, 80 Fed. Reg. 14 174 (Mar. 18, 2015) ("Equity Rule Amendment Filing") available at [www.finra.org/sites/default/files/rule\\_filing\\_file/SR-FINRA-2014-047%20-%20Amendment%20No.%201.pdf](http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2014-047%20-%20Amendment%20No.%201.pdf) (The text of the Rule appears at Exhibit 5.); and Notice of Filing of Amendment No. 1 to a Proposed Rule Change to Adopt FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports), Release No. 34-74490, 80 Fed. Reg. 14198 (Mar. 18, 2015) ("Debt Rule Amendment Filing") available at [www.finra.org/sites/default/files/rule\\_filing\\_file/SR-FINRA-2014-048%20-%20Amendment%20No.%201.pdf](http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2014-048%20-%20Amendment%20No.%201.pdf) (The text of the Rule appears at Exhibit 5).

interest rules.<sup>4</sup> Some of these changes (such as the reduction and elimination of quiet periods) are intended to reduce compliance burdens on firms.<sup>5</sup>

On the fixed income side, FINRA Rule 2242 represents the first rule that specifically and exclusively addresses debt research conflicts of interest. Similar to the definition of “research report” in SEC Regulation AC and NASD Rule 2711, “debt research report” is defined as “any written (including electronic) 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 Rule 2241(a)(11).”<sup>6</sup> This definition has certain enumerated exclusions (such as for analysis prepared for fewer than 15 persons), which are also consistent with the exclusions in Regulation AC and NASD Rule 2711.

While FINRA Rule 2242 is based on the current equity research rule framework, there are important differences, in recognition of the unique nature of the fixed income markets and the conflicts in those markets. Similarly, although this Rule is consistent with many aspects of the 2004 Bond Market Association Guiding Principles to Promote the Integrity of Fixed Income Research, it includes many more restrictions and requirements.<sup>7</sup> In some respects, Rule 2242 contains more restrictions and prohibitions than the equity research rules (in particular, with regard to input into analyst compensation and supervision of analysts by sales and trading personnel). In other respects, the requirements of Rule 2242 are less onerous (in particular, with regard to required disclosures in debt research reports). Importantly, Rule 2242 takes a “tiered approach” for “institutional” and “retail” research. Under this approach, the Rule applies extensive structural protections, disclosures and other requirements to “retail debt research,” but exempts debt research provided exclusively to qualifying institutional investors from many of these requirements.

In terms of process and timing, FINRA is required to publish a Regulatory Notice no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval. FINRA has stated that it is sensitive to the time that firms will need to comply with the Research Rules and will take this into consideration when establishing implementation dates. This recognition is critical, considering the significantly expanded principles-based and other requirements that will require updates not only to policies and procedures, but in some cases, firms’ systems, structures and reporting lines.

Section I of this Client Alert first outlines the areas of commonality for the Research Rules, given the significant overlap of the new requirements, prohibitions and other provisions in FINRA Rules 2241 and 2242 for equity and debt research. Next, Section II discusses the provisions that are exclusively applicable to equity research and, finally, Section III addresses provisions solely relevant to debt research (in particular, the “institutional research” exemption).

## **I. AREAS OF COMMONALITY: FINRA RULES 2241 AND 2242**

While there are important differences in the Research Rules that reflect differences in the equity and fixed income markets and the nature of research for those markets, there also are numerous areas of overlap for equity research and debt research. These areas are discussed below, with key differences noted. Except as specifically noted, these provisions do not apply to debt research that qualifies for the “institutional research” exemption.

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<sup>4</sup> Joint Report by NASD and the NYSE On the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (Dec. 2005) *available at* [www.finra.org/sites/default/files/Industry/p015803.pdf](http://www.finra.org/sites/default/files/Industry/p015803.pdf).

<sup>5</sup> For example, the Rules eliminate the requirement to annually attest that the firm has in place written supervisory policies and procedures reasonably designed to achieve compliance with the applicable provisions of the rules and amend the definition of “research analyst” for purposes of the analyst registration requirements to limit these requirements to persons whose primary job function is to provide investment research.

<sup>6</sup> See FINRA Rule 2242(a)(4). “Debt security,” in turn, means any “security” as defined in Section 3(a)(10) of the Exchange Act, except for any “equity security” as defined in Section 3(a)(11) of the Exchange Act, any “municipal security” as defined in Section 3(a)(29) of the Exchange Act, any “security-based swap” as defined in Section 3(a)(68) of the Exchange Act, and any “U.S. Treasury Security” as defined in paragraph (p) of Rule 6710.

<sup>7</sup> These voluntary guidelines were adopted by the industry as principles designed to help firms manage potential conflicts of interest that may arise in their fixed income research activities. See Guiding Principles To Promote Integrity of Fixed Income Research, *available at* [www.sifma.org/services/standard-forms-and-documentation/cross-product/cross-product\\_guiding-principles-to-promote-integrity-of-fixed-income-research/](http://www.sifma.org/services/standard-forms-and-documentation/cross-product/cross-product_guiding-principles-to-promote-integrity-of-fixed-income-research/).

- a. Identifying and Managing Conflicts of Interest.** Unlike NASD Rule 2711, the Research Rules take both a prescriptive and principles-based approach. In addition to containing specific requirements, prohibitions and restrictions, the Rules contain broad language governing the identification and management of conflicts of interest, which require the implementation of procedures that go above and beyond the explicit provisions of the Rules. Specifically, the Rules require member firms to establish, maintain and enforce written policies and procedures reasonably designed to: (i) identify and effectively manage conflicts of interest related to the preparation, content and distribution of research reports, public appearances by research analysts, and the interaction between research analysts and non-research personnel; and (ii) promote objective and reliable research that reflects the truly held opinions of research analysts and prevent the use of research reports or research analysts to manipulate or condition the market or favor the interests of the member or a current or prospective customer or class of customers.<sup>8</sup>
- b. Prohibitions and Restrictions on Pre-Publication Review of Research.** The Research Rules generally incorporate the provisions in NASD Rule 2711 regarding restrictions on the pre-publication review of research reports by non-research personnel and subject companies/issuers.<sup>9</sup> However, with respect to equity research reports, they are more restrictive than NASD Rule 2711 by requiring firms also to prohibit (not merely restrict) investment banking personnel's review of draft equity reports. Rule 2241 also eliminated the NASD Rule 2711 provision that permitted firms to notify a subject company of a rating change involving its securities. On the debt side, Rule 2242 is even more restrictive by requiring firms to prohibit (not merely restrict) review by investment banking personnel, principal trading personnel and sales/trading personnel of draft debt research reports that do not qualify as institutional debt research.<sup>10</sup> For institutional debt research, this prohibition extends only to investment banking personnel; it is also subject to the restrictions on the review of research by subject companies/issuers.<sup>11</sup>
- c. Restrictions on Input into Coverage.** The Research Rules incorporate the explicit restrictions relating to coverage determinations that appear in the Global Research Settlement. In particular, on the equity side, they require firms to restrict or limit input by investment banking department personnel into equity research coverage decisions, to ensure that research management independently makes all final decisions regarding the research coverage plan.<sup>12</sup> On the debt side, the Rule is more strict by requiring firms to limit or restrict input by sales/trading and principal trading personnel as well as by investment banking personnel.<sup>13</sup>
- d. Restrictions on Input into Budget.** The Research Rules also incorporate the explicit restrictions relating to budget determinations that appear in the Global Research Settlement. In particular, they limit determination of the budget to senior management, excluding persons engaged in investment banking activities.<sup>14</sup> On the debt side, this exclusion also applies to principal trading personnel.<sup>15</sup>
- e. Prohibitions on Supervision and Compensation Input.** The Research Rules incorporate the prohibitions currently in NASD Rule 2711 on investment banking personnel supervising or controlling research analysts and having input into compensation determinations. On the debt side, these prohibitions are broader because they apply not only to supervision and compensation input by investment banking personnel, but also to supervision and compensation

<sup>8</sup> See Equity Adopting Release, *supra* note 1, at 43482; Debt Adopting Release, *supra* note 1, at 43530.

<sup>9</sup> See FINRA Rule 2241(b)(2)(A), (N) and Supplementary Material .05; FINRA Rule 2242(b)(2)(B), (N) and Supplementary Material .05.

<sup>10</sup> See FINRA Rule 2241(b)(2)(A) and (N) and Supplementary Material .05; FINRA Rule 2242(b)(A), (B) and (N) and Supplementary Material .05. Under Rules 2241(a)(12) and 2242(a)(15), "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. Although FINRA has not defined "principal trading," FINRA has noted that it will consider providing guidance where it is unclear whether a particular job function or activity falls within "principal trading" activities.

<sup>11</sup> See FINRA Rule 2242(j)(2).

<sup>12</sup> See FINRA Rule 2241(b)(2)(B).

<sup>13</sup> See FINRA Rule 2242(b)(2)(C).

<sup>14</sup> See FINRA Rule 2241(b)(2)(D).

<sup>15</sup> See FINRA Rule 2242(b)(2)(E).

input by persons engaged in principal trading.<sup>16</sup> While the Rule also prohibits persons engaged in sales/trading activities from supervising debt research analysts, these personnel (unlike principal trading and investment banking personnel) may provide input to debt research management in order to convey customer feedback, provided that research management makes the final compensation decision (subject to the compensation committee's review and approval).<sup>17</sup>

- f. **Analyst Compensation.** The Research Rules incorporate many of the NASD Rule 2711 provisions relating to analyst compensation, although these provisions are more restrictive on the debt side. Specifically, the Research Rules prohibit compensation of equity research analysts and debt research analysts based on specific investment banking services or contributions to a member's investment banking services activities.<sup>18</sup> On the debt side, the Rule also prohibits compensation based on specific trading transactions and contributions to principal trading activities.

Also like NASD Rule 2711, the Research Rules require the creation of a committee to review and approve certain research analysts' compensation based on specific factors, and document the basis for their approval. These factors include: (i) the research analyst's individual performance, including the analyst's productivity and the quality of research, (ii) the overall ratings received from customers and peers and other independent ratings services, and (iii) for equity research analysts, the correlation between the research analyst's recommendations and the performance of the recommended securities. As noted above in item l.e, on the debt side, sales/trading personnel (but not principal trading personnel or investment banking personnel) may provide debt research management with input into the evaluation of a debt research analyst in order to convey customer feedback, provided that final compensation determinations are made by research management (subject to review and approval by the committee).

- g. **Prohibition on Retaliation and Promises of Favorable Research.** The Research Rules incorporate the provisions in NASD Rule 2711 that currently require firms to prohibit (i) the direct or indirect retaliation or threat of retaliation against research analysts by any employee of the firm for unfavorable research coverage or public appearances, and (ii) the direct or indirect promise of favorable research (including a specific rating or price target) or the threat to change such research as consideration or inducement for the receipt of business or compensation.<sup>19</sup> This prohibition applies to all debt research analysts, including those who write only institutional debt research.
- h. **Information Barriers or Institutional Safeguards.** The Research Rules incorporate a new, more general requirement that firms establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from the *review, pressure or oversight* of persons engaged in: (i) investment banking services activities; and (ii) other persons (including principal trading and sales/trading personnel) who might be biased in their judgment or supervision.<sup>20</sup> These new requirements are separate from and in addition to the restrictions and prohibitions on supervision, compensation input and review of research described above. Debt analysts who write only institutional debt research must be insulated only from pressure from these persons.
- i. **Personal Account Trading.** The most notable area where FINRA's principles-based approach benefits firms by providing more flexibility is personal account trading.<sup>21</sup> The Research Analyst

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<sup>16</sup> See FINRA Rule 2241(b)(2)(C); FINRA Rule 2242(b)(2)(D).

<sup>17</sup> See FINRA Rule 2242(b)(2)(D) and (G).

<sup>18</sup> See FINRA Rule 2241(b)(2)(E)-(F); FINRA Rule 2242(b)(2)(F)-(G).

<sup>19</sup> See FINRA Rule 2241(b)(2)(H) and (K); FINRA Rule 2242(b)(2)(I) and (K).

<sup>20</sup> See FINRA Rule 2241(b)(2)(G); FINRA Rule 2242(b)(2)(H). FINRA has interpreted this requirement to permit member firms to continue to have persons engaged in sales and trading activities provide informal and formal feedback on research analysts as one factor to be considered by research management for evaluative purposes, as has been the historical practice throughout the industry (assuming that such feedback and review is consistent with other provisions of Rules 2241 and 2422). Specifically, FINRA agrees with the interpretation that Rules 2241(b)(2)(G) and 2242(b)(2)(H) require member firms to establish policies, procedures, and controls to insulate or protect research analysts from being evaluated on the basis of inappropriate or improper reviews by such persons; for example, negatively reviewing an analyst for failing to give a "heads up" on a rating change.

<sup>21</sup> See FINRA Rule 2241(b)(2)(J); FINRA Rule 2242(b)(2)(J).

Rules eliminate many of the specific restrictions and prohibitions regarding personal trading in NASD Rule 2711. Instead, they require firms to more generally restrict or limit analyst personal account trading in the securities, derivatives and funds related to the securities the analyst covers in order to:

- ensure that research analyst accounts, supervisors of research analysts, and associated persons with the ability to influence the content of research reports do not benefit in their trading from knowledge of the content or timing of a research report before the intended recipients of such research have had a reasonable opportunity to act on the information in the research report;
- provide that no research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the member; and
- on the equity side, prohibit a research analyst account from purchasing or receiving any security before an issuer's IPO if the issuer is principally engaged in the same types of business as companies that the research analyst follows.<sup>22</sup>

Notably, firms are afforded flexibility to define financial hardship circumstances, if any, in which they will permit an analyst account to trade in a manner inconsistent with the analyst's most recently published recommendation.<sup>23</sup>

- j. Conflicts Related to Investment Banking Transactions.** The Research Rules incorporate key conflict provisions from Rule 2711 relating to investment banking transactions. In particular, they require firms to restrict or limit activities by research analysts that can reasonably be expected to compromise the analyst's objectivity, including participation in efforts to solicit investment banking transactions and road shows.<sup>24</sup> They also prohibit investment banking department personnel from directing analysts to engage in sales or marketing efforts or any communication with a customer about an investment banking services transaction.<sup>25</sup> These prohibitions apply to all equity and debt research analysts, including debt research analysts who only write institutional debt research.<sup>26</sup>

The Supplementary Materials provide additional guidance regarding the Rules' prohibition on the solicitation of investment banking business and joint due diligence. For example, the Supplementary Materials prohibit in pitch materials any information about a member's research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable research coverage; such information would include an analyst's industry ranking.<sup>27</sup> The Supplementary Materials also prohibits the performance of joint due diligence, *i.e.*, due diligence by a research analyst in the presence of investment banking department personnel, during the period prior to the selection by the issuer of the underwriters for the investment banking services transaction.<sup>28</sup>

Additionally, the Supplementary Materials clarify the restrictions on sales and marketing efforts. Specifically, no research analyst may engage in any three-way meeting with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction. Additionally, any written or oral communication by a research analyst with a current or prospective customer or internal personnel

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<sup>22</sup> See FINRA Rule 2241(b)(2)(J)(iii).

<sup>23</sup> The Supplementary Material in the Research Rules also permit research analysts to liquidate holdings pursuant to firm policy when certain criteria are met.

<sup>24</sup> See FINRA Rule 2241(b)(2)(L) and Supplementary Material .01; FINRA Rule 2242(b)(2)(L) and Supplementary Material .01.

<sup>25</sup> See FINRA Rule 2241(b)(2)(M) and Supplementary Material .03(a); FINRA Rule 2242(b)(2)(M) and Supplementary Material .02(a).

<sup>26</sup> See FINRA Rule 2242(j)(2).

<sup>27</sup> See FINRA Rule 2241 Supplementary Material .01; FINRA Rule 2242 Supplementary Material .01.

<sup>28</sup> See FINRA Rule 2241 Supplementary Material .02; FINRA Rule 2242 Supplementary Material .09.



related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.<sup>29</sup>

**k. Disclosure and Content Requirements.** The Research Rules incorporate many of the content and disclosure requirements currently contained in NASD Rule 2711. These requirements are highlighted below.

- *Disclosures in Research Reports Regarding the Firm's Ratings and Valuations.* The Research Rules' disclosure requirements largely mirror the rating and price target disclosure requirements currently in NASD Rule 2711; some of these requirements are highlighted below:
  - Whereas NASD Rule 2711 only required a discussion of valuation methods and associated risks in an equity research report if the research report contains a price target, the Rules require a description of valuation methods and associated risks in any equity or debt research report that contains a recommendation, rating or price target.<sup>30</sup>
  - As with NASD Rule 2711, where a rating system is employed, members must define in each equity or debt research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based, consistent with its plain meaning. A member must include in each equity research report that includes a rating, the percentage of all securities rated by the member to which the member would assign a "buy," "hold" or "sell" rating, and the percentage of subject companies within each category for which the member has provided investment banking services within the previous twelve months.<sup>31</sup> A member must include in each debt research report that is limited to the analysis of an issuer of a debt security and includes a rating of the issuer (not the individual securities), the percentage of all debt issuers rated by the member to which the member would assign a "buy," "hold," or "sell" rating, and the percentage of subject companies within each category for which the member has provided investment banking services within the previous twelve months.<sup>32</sup>
  - For equity research reports, if a research report contains a rating or price target for a subject company's security that have been assigned for at least one year, the research report must provide a line graph with the same parameters and requirements as currently required by NASD Rule 2711.<sup>33</sup> For debt research reports limited to the analysis of an issuer of a debt security, where a firm has assigned a rating for an issuer for at least one year, the report must show each date on which the rating was assigned and the rating that was assigned. Firms must include this information for the period that the member has assigned any rating or for a three-year period, whichever is shorter.<sup>34</sup>
- *Disclosures in Research Reports and Public Appearances Regarding Analysts' and Firms' Financial Interests in Issuer.* The Research Rules include the disclosure requirements currently in NASD Rule 2711 regarding financial ownership interests, with a modification to specify that certain disclosure requirements also apply to financial interests in the *debt* of the issuer. Specifically, the Rules require disclosure if an equity or debt research analyst or a member of the research analyst's household has a financial interest in the *debt or equity* securities of the subject company/issuer (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), and the nature of such interest.<sup>35</sup>

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<sup>29</sup> See FINRA Rule 2241 Supplementary Material .03; FINRA Rule 2242 Supplementary Material .02.

<sup>30</sup> FINRA Rules 2241(c)(1) and 2242(c)(1) extend the requirement to include valuation methods used to determine price targets and to include risks that would impede the achievement of a price target outlined in NASD Rule 2711(h)(7) to research reports that include recommendations and ratings.

<sup>31</sup> See FINRA Rule 2241(c)(2).

<sup>32</sup> See FINRA Rule 2242(c)(2).

<sup>33</sup> See FINRA Rule 2241(c)(3).

<sup>34</sup> See FINRA Rule 2242(c)(3).

<sup>35</sup> See FINRA Rule 2241 (c)(4)(A) and (d)(1)(A); FINRA Rule 2242 (c)(4)(A) and (d)(1)(A).

For equity research, firms must also disclose if the firm or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company.<sup>36</sup>

- *Disclosures in Research Reports and Public Appearances Regarding Compensation & Services Rendered.* The Research Rules require substantially the same disclosures regarding compensation and client relationships that currently appear in NASD Rule 2711. In particular, the Research Rules require disclosure:
  - if an equity or debt research analyst has received compensation based upon (among other factors) the member's investment banking revenues.<sup>37</sup> (Note that for debt research analysts, Rule 2242 also requires disclosure of compensation received based on a firm's *sales and trading or principal trading revenues.*);
  - if a member or any of its affiliates (i) managed or co-managed a public offering of securities for the subject issuer in the past 12 months; (ii) received compensation for investment banking services from the subject issuer in the past 12 months; or (iii) expects to receive or intends to seek compensation for investment banking services from the subject issuer in the next three months;<sup>38</sup>
  - if, as of the end of the month immediately preceding the date of publication or distribution of a research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month), the member or its affiliates has received from the subject issuer any compensation for products or services other than investment banking services in the previous 12 months;<sup>39</sup>
  - if the subject issuer is, or over the 12-month period preceding the date of publication or distribution of the research report has been, a client of the member, and if so, the types of services provided to the issuer (such services, if applicable, shall be identified as either investment banking services, non-investment banking securities-related services or non-securities services); and<sup>40</sup>
  - if the research analyst, the member or any affiliate received any compensation from the subject issuer in the previous 12 months.<sup>41</sup>
- *Disclosures in Research Reports Regarding Marketmaking or Principal Trading.* On the equity side, similar to current NASD Rule 2711, FINRA Rule 2241 retains the requirement to disclose whether the firm was making a market in the securities of the subject company.<sup>42</sup> On the debt side, firms must disclose if they trade or may trade as principal in the debt securities (or in related derivatives) that are the subject of the report.<sup>43</sup>
- *Catch-all Disclosures for "Other Material Conflicts."* The Research Rules adopt and expand on the NASD Rule 2711 catch-all disclosure requirement for "other material conflicts" of the research analyst or firm that the analyst knows or has reason to know. Specifically, the Rules also require firms to disclose in research reports other material conflicts of interest of the

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<sup>36</sup> See FINRA Rule 2241 (c)(4)(F) and (d)(1)(B).

<sup>37</sup> See FINRA Rule 2241 (c)(4)(B); FINRA Rule 2242 (c)(4)(B).

<sup>38</sup> See FINRA Rule 2241 (c)(4)(C); FINRA Rule 2242 (c)(4)(C).

<sup>39</sup> See FINRA Rule 2241 (c)(4)(D); FINRA Rule 2242 (c)(4)(D).

<sup>40</sup> See FINRA Rule 2241 (c)(4)(E) and (d)(1)(E); FINRA Rule 2242 (c)(4)(E) and (d)(1)(D). This disclosure is required in public appearances only to the extent that the analyst knows or has reason to know.

<sup>41</sup> See FINRA Rule 2241 (c)(4)(H) and (d)(1)(C)-(D); FINRA Rule 2242 (c)(4)(G) and (d)(1)(B)-(C).

<sup>42</sup> See FINRA Rule 2241(c)(1)(G).

<sup>43</sup> See FINRA Rule 2242(c)(4)(F).

research analyst or the firm “that an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know.”<sup>44</sup>

- **Disclosure Exemption.** Similar to NASD Rule 2711, the Research Rules adopt and expand on the exemption from certain disclosure requirements where such disclosure would reveal material non-public information regarding specific potential future investment banking transactions of the subject company. In particular, the Rules provide the exemption in any instance where the disclosure would reveal material non-public information regarding specific potential future investment banking transactions, even where the transaction does not relate to the subject issuer.<sup>45</sup>
- **Must Be Reliable and Provide a Reasonable Basis:** The Research Rules also introduce an explicit requirement that firms establish, maintain, and enforce written policies and procedures reasonably designed to ensure that: (i) purported facts in the research reports are based on reliable information; and (ii) any recommendation, rating, or price target (for equity research) has a reasonable basis and is accompanied by a clear explanation of any valuation method used and a fair representation of the risks that may impede achievement of those research views.

**I. Selective Dissemination Prohibitions.** The Research Rules codify an existing interpretation of FINRA Rule 2010 prohibiting selective dissemination of research and provide additional guidance through Supplementary Material. Specifically, they require 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. Under this provision and as clarified by Supplementary Material, a firm is permitted to provide different research products or services to different classes of customers, but is prohibited from differentiating a research product based on the timing of receipt of a recommendation, rating, or other potentially market moving information. If a firm does provide different research products and services for different customers, however, it must disclose to its customers that the alternative research products and services may reach different conclusions or recommendations that could impact the price of the security or result in short-term price movements contrary to its recommendations.<sup>46</sup>

**m. Distribution of Third-Party Research Reports.** Similar to NASD Rule 2711, under the Research Rules, firms that distribute third-party equity or debt research must (i) adopt written policies and procedures that are reasonably designed to ensure that any third-party research contains no untrue statement of material fact and is not otherwise false or misleading (unless the report can qualify as “independent third party research”; (ii) prohibit the distribution of third-party research the firm knows or has reason to know is not objective or reliable (and subject non-independent third-party reports to certain review requirements); and (iii) accompany certain third-party research with specified disclosures, including disclosure of any material conflict of interest that can reasonably be expected to have influenced the firm’s choice of a third-party research provider or the subject company of a third-party research report.<sup>47</sup>

**n. Exemptions.**

- **Firms with Limited Investment Banking Activity.** The Research Rules include an exemption from certain provisions for firms that engage in limited investment banking activity (*i.e.*, firms that during the previous three years, on average per year, have participated in 10 or fewer

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<sup>44</sup> See FINRA Rule 2241(c)(4)(I) and (d)(1)(F); see also Rule 2241 Supplementary Material .08 (clarifying the meaning of “ability to influence the content of a research report”). See FINRA Rule 2242(c)(4)(H) and (d)(1)(E); see also Rule 2242 Supplementary Material .07 (clarifying the meaning of “ability to influence the content of a research report”).

<sup>45</sup> See FINRA Rule 2241(c)(5) and (d)(2); FINRA Rule 2242(c)(5) and (d)(2).

<sup>46</sup> See FINRA Rule 2241(g) and Supplementary Material .07; FINRA Rule 2242(f) and Supplementary Material .06.

<sup>47</sup> See FINRA Rule 2241(h); FINRA Rule 2242(g).



investment banking services transactions and generated \$5 million or less in gross investment banking revenues).<sup>48</sup>

- **Exemption for Good Cause.** The Research Rules permit FINRA, in certain circumstances, to “conditionally or unconditionally” grant an exemption from any requirement of the Research Rules for good cause.<sup>49</sup>

## II. PROVISIONS SPECIFIC TO EQUITY RESEARCH AND EQUITY RESEARCH ANALYSTS

While FINRA Rules 2241 and 2242 overlap in numerous significant areas as outlined above, there are some notable provisions that are specific to equity research.

- Quiet Periods.** FINRA Rule 2241 reduces and eliminates the “quiet period” requirements currently in NASD Rule 2711. Firms will be required to specify periods during which they may not publish or distribute equity research reports or make public appearances relating to the issuer (with the exception of significant news or events or pursuant to Securities Act Rule 139 regarding an issuer with “actively-traded securities”).<sup>50</sup> For IPOs where the firm has participated as an underwriter or dealer, the quiet period must be a minimum of 10 days following the date of the IPO. For secondary offerings where the firm has acted as a manager or co-manager, the quiet period must be a minimum of three days following the date of the secondary offering.
- Termination of Coverage.** FINRA Rule 2241 maintains the “termination of coverage” requirements currently in NASD Rule 2711, without significant modification.
- JOBS Act.** As with NASD Rule 2711, FINRA has taken the position that it will interpret Rule 2241 in a manner consistent with the Jumpstart Our Business Startups Act (JOBS Act). For example, none of the quiet periods would apply to Emerging Growth Companies (EGCs), and the restrictions on joint due diligence would not apply to activities involving a communication with the management of an EGC that is attended by both the research analyst and an investment banker.<sup>51</sup>
- Removal of Attestation Requirement.** A notable NASD Rule 2711 provision that was eliminated in FINRA Rule 2241 is the annual attestation required by NASD Rule 2711(i). FINRA determined that a separate research-related attestation was unnecessary in light of the annual FINRA Rule 3130 certification.<sup>52</sup>

## III. PROVISIONS SPECIFIC TO DEBT RESEARCH AND DEBT RESEARCH ANALYSTS

The most notable differences between FINRA Rules 2241 and 2242 are (i) the exemptions in Rule 2242 for “institutional research” and firms with limited principal trading activity, and (ii) the more detailed requirement for information barriers between debt research analysts and trading desk personnel. These exemptions and this requirement are discussed below.

- Exemption for Debt Research Reports Provided to Institutional Investors.** Under the bifurcated or tiered approach for retail and institutional debt research, debt research that is provided to qualifying institutional investors is exempted from the majority of requirements, restrictions, and prohibitions in Rule 2242, provided that certain requirements are met.<sup>53</sup> This exemption may be used not only by “research department” personnel, but also sales and trading personnel who prepare materials that meet the broad definition of “debt research report.” In

<sup>48</sup> See FINRA Rule 2241(i); FINRA Rule 2242(h).

<sup>49</sup> See FINRA Rule 2241(j); FINRA Rule 2242(k).

<sup>50</sup> See FINRA Rule 2241(b)(2)(l).

<sup>51</sup> See Equity Adopting Release, *supra* note 1, at 43495.

<sup>52</sup> See Equity Adopting Release, *supra* note 1, at 43488.

<sup>53</sup> See Debt Adopting Release, *supra* note 1, at 43537; see also FINRA Rule 2242(j).

describing the institutional research exemption in its Initial Rule filing, FINRA noted that, while much debt research is prepared by a dedicated research department, trading desks may also generate market color, analyses and trading ideas that could fall within the definition of “debt research report,” and that the tiered structure for institutional research would recognize these different forms of debt research.<sup>54</sup>

- *Requirements for Qualifying as “Institutional Research.”* FINRA Rule 2242(j) exempts “institutional research” from almost all of the requirements of Rule 2242. In order for research to qualify as “institutional research,” member firms must limit the distribution of the research to only those persons who are qualified institutional buyers (QIBs) or “institutional accounts” (as defined in FINRA Rule 4512)<sup>55</sup> and meet the consent and other requirements below.
  - *QIBs – Negative Consent:* A firm may send institutional research to QIBs without obtaining their affirmative consent to receive this research (*i.e.*, QIBs would be required to affirmatively “opt-out” of the institutional research regime), provided that:
    - the firm, pursuant to FINRA’s suitability rule, has a reasonable basis to believe that the QIB is capable of evaluating investment risks independently, both in general and with regard to particular transactions in investment strategies involving a debt security or debt securities; and
    - the QIB has affirmatively indicated, with respect to transactions in debt securities, that it is exercising independent judgment in evaluating the firm’s recommendations.
  - *Other Institutional Investors – Affirmative Consent:* For institutional investors who do not qualify as QIBs, a firm must receive their affirmative consent in order to send them institutional research (*i.e.*, these customers must notify the member in writing that they wish to receive institutional debt research and forgo treatment as a retail investor for purposes of the debt research rule).
  - *Timeframe for Obtaining Consent.* Rule 2242 permits firms to obtain a one-time affirmative consent for any Rule 4512(c) institutional account and further provides a one-year grace period to obtain that consent, so as not to disrupt the current flow of debt research to institutional customers. This grace period is not available to natural persons who would otherwise qualify as institutional accounts.
  - *Prominent Disclosures:* To rely on the institutional research exemption, firms also need to include a prominent disclosure on the first page of each debt research report, stating that (i) the research is intended for institutional investors and is not subject to all independence and disclosure standards applicable to debt research reports provided to retail investors; (ii) if applicable, the research may be inconsistent with recommendations offered in the firm’s research that is disseminated to retail investors; and (iii) if applicable, the firm trades the securities covered in the research for its own account and on behalf of certain clients, and that such trading interests may be contrary to the recommendations offered in the research and the research may not be independent of the firm’s proprietary interests.
  - *Written Policies and Procedures:* Additionally, firms must establish, maintain and enforce written policies and procedures reasonably designed to ensure that institutional debt research is made available only to eligible institutional investors.

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<sup>54</sup> See Initial Debt Rule Filing, *supra* note 3, at 69907.

<sup>55</sup> This definition includes (A) a bank, savings and loan association, insurance company or registered investment company; (B) an investment adviser that is registered with the SEC or with a state securities authority; or (C) any other entity (including a natural person) with at least \$50 million in total assets.

- *Baseline Requirements Applicable to “Institutional Research.”* As noted above, Rule 2242(j) would exempt institutional research from almost all of the requirements of Rule 2242, except that member firms would be required to establish policies and procedures to:
  - prohibit the prepublication review, clearance, or approval of debt research reports by investment banking personnel for any purpose, or a subject company (except for verification of facts);
  - establish information barriers or other institutional safeguards reasonably designed to ensure that debt analysts are insulated from *pressure* by persons engaged in investment banking, principal trading, sales or trading, and others persons who may be biased in their judgment or supervision;
  - prohibit direct or indirect retaliation or threat for unfavorable research;
  - prohibit explicit or implicit promises of favorable research, a particular rating or recommendation, or specific content as inducement for the receipt of business or compensation;
  - restrict or limit activities by analysts that can reasonably be expected to compromise their objectivity, including analyst participation in pitches and road shows;
  - prohibit investment banking personnel from directing a debt analyst to engage in sales or marketing or any communication with a customer about an investment banking transaction; and
  - prohibit analysts from attending meetings with customers regarding an investment banking transaction where investment banking or issuer management personnel are present.
- b. Exemption for Firms with Limited Principal Trading Activity.** FINRA Rule 2242 also includes an exemption from certain provisions for firms with limited principal trading activity (*i.e.*, exempting firms that have (i) gains or losses of \$15 million or less from principal debt trading activity over the previous three years and (ii) fewer than 10 debt traders).
- c. Information Barriers between Debt Research Analysts and Trading Desk Personnel.** The Supplementary Material to Rule 2242 requires firms to adopt information barriers to prohibit sales and trading and principal trading personnel from improperly attempting to influence a debt research analyst’s opinion or views. It provides examples of impermissible and permissible communications between debt research analysts and non-research personnel, in addition to examples of specific policies and procedures that firms should adopt to comply with this provision.<sup>56</sup>

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While the extensive rulemaking record here provides additional guidance on many issues raised by these principle-based rules, we expect that new issues will arise as firms absorb the Rules and put them into practice.

FOR MORE INFORMATION ON THIS OR OTHER SECURITIES MATTERS, CONTACT:

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<sup>56</sup> See FINRA Rule 2242 Supplementary Material .03. While the proposed rule does not require physical separation, FINRA has expressed its expectation of physical barriers “except in extraordinary circumstances where the costs are unreasonable due to a firm’s size and resource limitations.” See Debt Adopting Release, *supra* note 1, at 43543.

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