Will Principles-Based Guidance be Easier to Follow?

A Brief Summary of Proposed Changes to FINRA's Research Rules

By Anna Pinedo

Practitioners and market participants often complain that rules and regulations ought to be principles-based rather than prescriptive. In advocating for principles-based regulation, the argument is often made that the objectives underlying the rules and regulations should be clear to those subject to compliance requirements. In November 2014, the Financial Industry Regulatory Authority, Inc., or FINRA, filed a proposed rule change with the Securities and Exchange Commission, or the SEC, which was subsequently amended in early 2015, to adopt NASD Rule 2711 (the equity research rule) as new FINRA Rule 2241 with significant modifications. Although the proposed changes generally retain many of the principal provisions of Rule 2711, proposed Rule 2241 represents a shift in approach. The proposed rule relies on a principles-based approach that puts more emphasis on the effective design and monitoring of a member firm's compliance policies and procedures to mitigate and avoid conflicts of interest. As such, in preparing for the new rule, member firms may be required to take a more holistic approach to reviewing and revising their policies and procedures and undertake a more rigorous look at the types of activities that may pose conflicts of interest or be perceived as improperly influencing research. In addition to implementing this new approach, proposed Rule 2241 attempts to establish a level playing field as between investment banks subject to the Global Settlement and those that are not, as well as establish a level playing field in the treatment of research relating to issuers that are emerging growth companies, or EGCs, and those that are not. At the same time that it filed the proposed rule change relating to equity research, FINRA also filed a rule proposal relating to debt research, which is substantially similar although it takes into account the fact that debt research generally is more oriented at institutional investors.

Identifying and Managing Conflicts of Interest – Rule 2241(b)

Rule 2241(b), titled "Identifying and Managing Conflicts of Interest," sets forth the principles underlying the revised rule. It requires member firms to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to (a) the preparation, content and distribution of research reports, (b) public appearances by research analysts, and (c) 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 Supplemental Material that forms part of the rule itself includes some prescriptive requirements addressing areas in which FINRA believes there is heightened risk of undue influence being applied to research. For example, in Supplemental Material .02, "Joint Due Diligence," FINRA states that it interprets clause (c) above to prohibit joint due diligence sessions involving a research analyst in the presence of investment banking department personnel *prior* to the selection by the issuer of the underwriters for the investment banking transaction. Once a mandate has been awarded, FINRA believes joint due diligence sessions may take place in accordance with appropriate policies and procedures.

ABOUT THE AUTHOR

Anna Pinedo is a Partner with Morrison Foerster LLP, www.mofo.com. She can be reached at apinedo@mofo.com.

Principal Areas to be Addressed by Member Firms

Rule 2241(b)(2) outlines the principal matters to be addressed by member firms in their policies and procedures. These include the following:

- *Prepublication Review*: Policies and procedures should prohibit prepublication review, clearance or approval of research reports by persons engaged in investment banking services activities and restrict or prohibit such review, clearance or approval by other persons not directly responsible for the preparation, content and distribution of research reports, other than legal and compliance personnel. The new rule eliminates the current provision of Rule 2711 that permits pre-publication review of research reports by investment banking to verify the factual accuracy of information in a research report. FINRA stated that it believes that review of facts in a report by investment banking is unnecessary in light of the numerous other sources available to verify factual information, including the subject company, and only raises concerns about the objectivity of the report and invites pressure on a research analyst. The proposed rule requires policies and procedures reasonably designed to at least restrict prepublication review by other non-research personnel, other than legal and compliance personnel. A firm must specify in its policies and procedures the circumstances, if any, under which such review would be permitted as necessary and appropriate; for example, where non-research personnel are best situated to verify selected facts or where administrative personnel review a report for formatting.
- *Coverage Decisions*: Policies and procedures must restrict or limit input by the investment banking department into research coverage decisions to ensure that research management independently makes all final decisions regarding the research coverage plan. This provision makes express FINRA's interpretation that the separation requirements in current Rule 2711(b)(1) prohibit investment banking personnel from making final coverage decisions. The proposed rule does not preclude investment banking personnel from conveying customer interests or providing input into coverage considerations, so long as final decisions regarding the coverage plan are made by research management.
- *Supervision, Oversight, Control and Compensation*: Policies and procedures must prohibit persons engaged in investment banking activities from supervising or controlling research analysts, including exerting influence or control over research analyst compensation evaluation and determination. Member firms should limit determination of research department budget to senior management, excluding senior management engaged in investment banking services activities. Similarly, member firm policies and procedures should prohibit research personnel compensation based upon specific investment banking transactions or contributions to a member firm's investment banking activities. At least annually, a committee that reports to the member firm's board of directors, must

review and approve the compensation of a research analyst who is primarily responsible for preparation of the substance of a research report. This committee may not include representation from the member's investment banking department. The committee must consider the following factors when reviewing a research analyst's compensation, if applicable, and document its determinations: the research analyst's individual performance, including the analyst's productivity and the quality of the analyst's research; the correlation between the research analyst's recommendations and the performance of the recommended securities; and the overall ratings received from clients, sales force and peers independent of the member's investment banking department, and other independent ratings services.

- *Separation and Information Walls*: A member firm must establish information barriers or other institutional safeguards to ensure that research analysts are insulated from review, pressure or oversight by persons engaged in investment banking activities or other persons, including sales and trading department personnel. FINRA expanded the concept of separation to include "other persons, including sales and trading department personnel, who might be biased in their judgment or supervision."

- *Anti-Retaliation*: Member firms must prohibit direct or indirect retaliation or the threat of retaliation against research analysts employed by the member firm or its affiliates by persons engaged in investment banking services activities or other employees as the result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the member firm's present or prospective business interests;

- *Quiet Periods*: Policies and procedures should define periods during which the member firm must not publish or otherwise distribute research reports, and during which period research analysts must not make public appearances, relating to the issuer, of: a minimum of 10 days following the date of an initial public offering if the member firm has participated as an underwriter or dealer in the initial public offering; or a minimum of three days following the date of a secondary offering if the member firm has acted as a manager or co-manager of that offering. Of course, as a result of the JOBS Act, the IPO quiet period referenced immediately above would not apply to the publication or distribution of a research report or a public appearance following an initial public offering or secondary offering of the securities of an EGC. The proposed rule substantially shortens the quiet period, eliminates the differing treatment of managing underwriters and the other underwriters in the offering, and also eliminates the current quiet periods 15 days before and after the expiration, waiver or termination of a lock-up agreement.

- *Restrictions on Trading; Analyst Objectivity*: The proposed rule requires that a member firm restrict or limit research analyst account trading in securities, as well as derivatives of such securities and funds whose performance materially depends upon the performance of securities covered by the research analyst. The proposed rule sets out a broader, more encompassing approach designed to prohibit an analyst from benefitting economically from the knowledge of the contents or timing of a report and from trading in a manner that is inconsistent with the analyst's recommendations. Member firms also must 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 or compensation. Policies and procedures should restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, including prohibiting participation in pitches and other solicitations of investment banking services transactions; and participation in road shows and other marketing on behalf of an issuer related to an investment banking services transaction. Similarly, investment banking department personnel are to be prohibited from, directly or indirectly, directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction; or directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction.

- *Content and Disclosure Requirements*: Proposed Rule 2241(c) sets forth the general principle that a member firm should adopt written policies and procedures relating to the content of, location of disclosures within, and procedures for, research reports. There are few changes from existing requirements although some are recast as policies and procedures rather than requirements. For example, Proposed Rule 2241(c)(1)(A) requires the adoption of policies and procedures reasonably designed to ensure that purported facts in the report are based on reliable information. In addition to proposed specific disclosure requirements regarding conflicts of interest that are substantively the same as existing requirements, the proposed rule expands the "catch all" disclosure provision by requiring disclosure of material conflicts known not only by the research analyst but also by any "associated person of the member with the ability to influence the content of a research report." FINRA's intention is to capture material conflicts that may be known only to a supervisor or the head of research. In FINRA's view, the "reason to know" standard would not impose a duty of inquiry on the research analysts or others but rather "it would cover disclosure of those conflicts that should reasonably be discovered by those persons in the ordinary course of discharging their functions. Proposed Rule 2241(c)(4)(F) expands the disclosure requirements relating to beneficial ownership of 1% or more of the securities of a subject company in order to include, in addition to common equity interests, to include debt and other forms of equity. FINRA stated that "an equity research report that analyzes the creditworthiness of the subject company could impact the price of the company's debt securities, and therefore a material conflict exists where the member or its affiliates maintains significant debt holdings in the subject company."

- *Public Appearances*: Proposed Rule 2241(d) is generally unchanged substantively from Rule 2711 with the addition of the requirement to disclose ownership of debt securities similar to Rule 2241(c)(4)(F). However the "catch all" disclosure requirement remains applicable only to the research analyst and would not be applicable to any other person, unlike current Rule 2241(c).

Conclusion

The proposed rule will become effective following receipt of SEC approval. As noted above, the debt research rules proposed by FINRA address debt research conflicts of interest. Largely, the construct of the equity and the debt research rules is similar; however the debt research rule includes exemptions for research distributed to certain institutional investors and also exemptions for firms with limited principal debt trading activity. We have produced a chart contrasting the provisions of the two proposed rules, which is available here: http://media.mofo.com/files/uploads/Images/FINRA-Rule-2241-Tracking-Chart.pdf. Once the rules are approved and become effective, we will see whether market participants find it compliance with principles-based regulation more appealing. ✦

NSCP LEGAL ALERT - *Holding Customer Checks: SEC "No Action" Letter Gives Significant Relief to Introducing Broker-Dealers.* Available to members - simply login and click the "Publications" tab and navigate to the "Legal Alerts" folder.