



July 31, 2015

SEC Approves FINRA Rule 2242 (Debt Research Analysts & Reports)

The Securities and Exchange Commission (“SEC”), has approved the adoption of new FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) to address conflicts of interest relating to the publication and distribution of debt research reports. FINRA Rule 2242 (“Debt Research Rules”) represents a tiered approach that, in general, would provide retail debt research recipients with extensive protections similar to those provided to recipients of equity research under FINRA rules, with modifications to reflect differences in the trading of debt securities.

Currently, FINRA’s research rules, NASD Rule 2711 (Research Analysts and Research Reports) and Incorporated NYSE Rule 472 (Communications with the Public) (collectively the “Equity Research Rules”), set forth requirements to foster objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions. The goal of the Equity Research Rules was to restore public confidence in the objectivity of research and the veracity of research analysts, which had eroded due to the pervasive influences of investment banking and other conflicts during the market boom of the late 1990s. Based upon recent market actions, FINRA believed that since the Equity Research Rules apply only to research reports that include analysis of an “equity security,” as that term is defined under the Exchange Act, subject to certain exceptions, a research rule addressing the conflicts of interest in the debt market was needed.

Notwithstanding the differences in the operation of the equity and debt markets, FINRA believes that many of the conflicts of interest in the publication and distribution of equity research are also present in debt research and that the Equity Research Rules have proven to be effective in mitigating conflicts of interest in the publication and distribution of equity research. Therefore, FINRA generally utilized a substantial portion of the Equity Research Rules and their basic framework to provide retail debt research recipients with extensive protections similar to those provided to recipients of equity research under current and proposed FINRA rules, with modifications to reflect the different nature and trading of debt securities.

The Key Differences

FINRA Rule 2242 differs from FINRA’s current Equity Research Rules in three key respects. First, the Debt Research Rule would delineate the prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel. These restrictions take into account the need to ration a debt research analyst’s resources among the multitude of debt securities, the limitations on price discovery in the debt markets, and the current

and prospective inventory. Second, the Debt Research Rule would exempt debt research provided solely to institutional investors from many of the structural protections and prescriptive disclosure requirements that apply to research reports distributed to retail investors. Finally, in addition to the exemption for limited investment banking activity found in the current and proposed Equity Research Rules, the Debt Research Rule has a similar additional exemption for limited principal trading activity. The Debt Research Rule would, in general, exempt members that engage in limited investment banking activity or those with limited principal trading activity and revenues generated from debt trading from the review, supervision, budget, and compensation provisions in the proposed rule related to investment banking activity or principal trading activity, respectively.

Areas of Commonality

With minor variations that either address the differences in issues facing debt and equity or are broader to reflect the increased regulatory focus on conflicts of interests and sales practices, there are a number of areas where the new Debt Research Rule generally incorporates provisions found in the Equity Research Rules. These areas of commonality include the (i) prohibitions and restrictions on pre-publication review of research; (ii) restrictions or limits on firms to limit input by investment banking department personnel into equity research coverage decisions (and has been expanded to include to principal trading personnel and sales and trading personnel); (iii) restrictions on who can provide input into budget (in addition to excluding investment banking, it also applies to principal trading personnel); (iv) prohibitions on supervision and compensation input by investment banking personnel (and principal trading personnel) supervising or controlling research analysts and having input into compensation determinations; (v) prohibition of analyst compensation based on specific investment banking services or contributions to a member's investment banking services and activities (again, the prohibition was expanded to include principal trading activities) and the creation of a committee to review and approve certain research analysts' compensation based on specific factors, and document the basis for their approval; (vi) prohibition on retaliation or threats for unfavorable research coverage and promises of favorable research for business or compensation; (vii) restrictions and or limitations on 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; (viii) disclosures and the content allowable in research reports; (ix) prohibitions on selective dissemination of research 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.

Hybrid Areas of Commonality

In a number of areas, including information barriers, conflict of interest and personal trading, FINRA drew on the framework provided by the Equity Research Rules, but expanded and adjusted them to reflect a more proscriptive approach. To that end:

- With respect to information barriers or institutional safeguards related to research reports, the Research Rules incorporate a 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 service activities; and (ii) other persons (including principal

trading and sales/trading personnel) who might be biased in their judgment or supervision.

- With respect to conflicts of interest, while both rules address the identification of conflicts of interest, the Debt Research Rule approaches the issue in a manner more consistent with the findings set forth in the FINRA Conflicts of Interest Report, which was issued by FINRA in October 2013. Thus, the Debt Research Rule takes both a prescriptive and principles-based approach. In addition to containing specific requirements, prohibitions and restrictions, the Debt Research Rule contains broad language governing the identification and management of conflicts of interest, and requires the implementation of procedures to address those issues by each firm. To comply with the Debt Research rule, those procedures must be 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.
- With respect to personal account trading, many of the specific restrictions and prohibitions regarding personal trading in NASD Rule 2711 are eliminated. 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.

Additionally, 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.

Exemptions

Firms with limited investment banking activity are exempt from the research rule. Firms that engage in limited investment banking activity are defined as those firms that during the previous three years, on average per year, have participated in 10 or fewer investment banking services

transactions and have generated \$5 million or less in gross investment banking revenues. FINRA also has the ability, in certain circumstances, to “conditionally or unconditionally” grant an exemption from any requirement of the Research Rules for good cause.

Effective Date

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following July 17, 2015; however, FINRA further stated that the effective date of the Research Rule will be no later than 180 days following publication of the Regulatory Notice announcing SEC approval (July 17, 2015).

We hope that this information has been helpful to you. Should you have any additional questions or concerns, please feel free to contact Daniel E. LeGaye or Michael Schaps by e-mail or phone, at 281-367-2454, or consult with your legal counsel or compliance consultant. This legal update has been provided to you courtesy of The LeGaye Law Firm, P.C., 2002 Timberloch Drive, Suite 200, The Woodlands, Texas 77380. Visit our web site at www.legayelaw.com.

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