

FINRA Proposes Desk Commentary Safe Harbor

The safe harbor would offer relief from certain requirements of FINRA's research rules, but significant compliance obligations and questions remain.

On April 12, 2017, the Financial Industry Regulatory Authority, Inc. (FINRA) published Regulatory Notice 17-16 (RN 17-16) requesting comment on proposed amendments to FINRA Rule 2241 (the Equity Research Rule) and FINRA Rule 2242 (the Debt Research Rule, and together with the Equity Research Rule, the Research Rules). The proposed amendments would provide for a limited safe harbor for certain written analysis prepared by sales and trading or principal trading personnel but which, depending on its content, may rise to the level of a "research report" under the Research Rules (the Proposed Safe Harbor).¹

Subject to compliance with a number of conditions, the Proposed Safe Harbor would relieve a FINRA member that produces and distributes such material (referred to as "desk commentary") from compliance with several of the Research Rules' conflict management provisions and disclosure requirements. The Proposed Safe Harbor would also exempt (1) desk commentary authors from compliance with the registration and qualification requirements for equity research analysts under NASD Rule 1050 and (2) associated persons who review equity desk commentary from the requirement to register as "research principals" under NASD Rule 1022. The Proposed Safe Harbor would not provide any relief with respect to such desk commentary if it is distributed to retail investors and would require firms to include a "health warning" and to obtain negative consent from eligible institutional investors to receive such commentary. FINRA also posed a number of questions to market participants in the regulatory notice regarding the potential economic impact of, and the conditions for, the Proposed Safe Harbor. The comment period for the Proposed Safe Harbor closes on May 30, 2017.²

Background

Desk commentary typically refers to sales material prepared by personnel sitting on a firm's sales and trading desk in response to certain trading events or news flashes.³ Such information is generally disseminated quickly and intended for institutional investors capable of exercising their own independent judgment and making their own trading decisions. Traditionally, such desk commentary has not been thought by most firms to constitute a "research report" for purposes of the Research Rules due to either insufficient analysis or because the communication falls into a specified exception to the definition of research report.⁴ FINRA has observed, however, that, in some cases, desk commentary may technically fall within the "research report" definition, even though it is not the type of "fundamental research" that the Research Rules were intended to capture.⁵ Given the difficulties in discerning between the types of communications that do and do not constitute "research reports," the Proposed Safe Harbor aims to

provide firms more compliance certainty in their review of sales and trading communications, while continuing to provide investor safeguards commensurate with the context and scope of the communications and the sophistication of the targeted recipients.

Safe Harbor Conditions

As noted above, the Proposed Safe Harbor would provide a non-exclusive safe harbor for eligible desk commentary from some — though not all — of the Research Rules' provisions. In order to be “eligible” for the Proposed Safe Harbor, the desk commentary must meet the following author, content and recipient conditions:

- **Author:** The communication must be 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's content limitation (described below)
 - Do not require registration as a research analyst pursuant to NASD Rule 1050 because their *primary* job function is not to provide investment research
 - Do not report directly or indirectly to research department personnel
- **Content:** The communication must be limited to “brief” observations (and must not include the author's 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.⁶ Significantly, FINRA does not define the term “brief” or provide any clear indication as to the types of communications that would be considered “brief,” nor does FINRA outline any parameters as to what amount of time is considered “near term.” Accordingly, these terms may represent additional challenges for firms seeking to utilize the Proposed Safe Harbor.
- **Recipient:** The communication may only be distributed to consenting investors (including certain natural persons) that meet the definition of “institutional account” under FINRA Rule 4512(c) (Customer Account Information) and from which the firm has received negative consent to receive the communications. In addition, the recipient condition of the Proposed Safe Harbor would limit distribution of desk commentary solely to those institutional accounts with respect to which the firm has met the institutional suitability standard set forth in FINRA Rule 2111(b).⁷ The necessary consent may be obtained by written disclosure to the institutional investor that the firm may provide the investor desk commentary from sales and trading or principal trading personnel that may, at times, constitute research reports under FINRA rules that 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. If the institutional investor does not contact the firm and request to receive only research reports subject to the full protections of the Research Rules, the firm may reasonably conclude that the institutional investor has consented to receiving communications for the purpose of the Proposed Safe Harbor.⁸

To the extent that each of the conditions are satisfied, the communication and its author would be exempt from all of the provisions of the Research Rules, except for those with which compliance is a specific condition of the Proposed Safe Harbor, as described below. Desk commentary that meets the definition of “research report” but falls outside of these conditions would be subject to the full scope of the applicable

Research Rules. However, FINRA notes that the content limitation is not intended to define such communications as “research reports” for the purposes of the Proposed Safe Harbor or other contexts and that FINRA would not preclude members from making their own considered determination that particular desk commentary does not constitute a research report and therefore is not subject, in any manner, to the Research Rules or to the conditions of the Proposed Safe Harbor.⁹

Conflict Management

In order to rely on the Proposed Safe Harbor, a firm would be required to establish, maintain and enforce written policies and procedures reasonably designed to:

- Prevent the use of research reports or research analysts to manipulate the market and prohibit prepublication review, clearance or approval of research reports by persons engaged in investment banking services activities
- Establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from pressure by persons engaged in investment banking services activities or other persons, including sales and trading personnel, who might be biased in their judgment or supervision
- Prohibit direct or indirect retaliation or threats of retaliation against research analysts by persons engaged in investment banking services activities or other employees as the result of an adverse, negative, or otherwise unfavorable research report written by the research analyst that may adversely affect the firm’s present or prospective business interests
- 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
- 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
 - Participation in road shows and other marketing on behalf of an issuer related to an investment banking services transaction
- Prohibit investment banking department personnel from directly or indirectly:
 - Directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction
 - Directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction
- Prohibit prepublication review of a research report by a subject company
- Prohibit research analysts from engaging in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction

FINRA members relying on the Proposed Safe Harbor would also be required 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 institutional investors. In addition, the Proposed Safe Harbor would not relieve a member of its obligations to comply with the anti-fraud provisions of the federal securities laws and FINRA rules, and would in no way impact a member's obligation to establish, maintain and enforce written procedures reasonably designed to prevent the dissemination of material non-public research information. Accordingly, firms would continue to be required to have written policies and procedures in place to prevent distributing desk commentary that incorporates internal material non-public information from the research department, such as changes in a research analyst's views on a company to be included in a subsequent research report.¹⁰ FINRA also noted that all desk commentary, whether eligible or not eligible for the Proposed Safe Harbor, would remain subject to the applicable provisions of FINRA Rule 2210 (Communications with the Public).¹¹

Notably, in describing the existing provisions of the Research Rules that must be complied with as conditions of the Proposed Safe Harbor, FINRA maintains the use of the term "research report" to mean the desk commentary that is eligible for the Proposed Safe Harbor and use of the term "research analyst" to mean the sales and trading or principal trading personnel who author such desk commentary.¹² While this approach may be expedient for drafting purposes, it is likely to promote confusion in connection with the application of the Proposed Safe Harbor and begs the question as to what extent an author of desk commentary could be considered a "research analyst" for other purposes. For example, although FINRA attempted to clarify that the restriction on activities by such "research analysts" is not intended to prohibit a person in the sales and trading or principal trading department from engaging in "ordinary course" communications related to the distribution of securities in an offering so long as the person was not concurrently publishing commentary related to the issuer or the investment banking transaction,¹³ it remains unclear the extent to which such personnel — who, by virtue of their job function, are involved in solicitation and marketing efforts in connection with investment banking activities — may participate in such activities and in other communications in which research analysts are not permitted to engage under the Research Rules. Moreover, this approach seemingly could only work if viewed on a case-by-case basis, i.e., sales and trading and principal trading personnel may be viewed as "research analysts" and subject to the conflict management provisions of the Proposed Safe Harbor with respect to certain investment banking transactions in which they are involved, but not others for which they have not produced desk commentary intended to be sheltered by the Proposed Safe Harbor or that otherwise rises to the level of a "research report" for purposes of the Research Rules.

Disclosure Requirement

The Proposed Safe Harbor would require desk commentary to carry a "health warning" similar to what is required for debt research distributed pursuant to the institutional debt research exemption in FINRA Rule 2242(j). The health warning would, among other things, state that the document is intended for institutional investors and that clients should assume that the document is not independent of the firm's proprietary interests.¹⁴

Additional Requirements for Equity Desk Commentary

The Proposed Safe Harbor would impose conditions for equity desk commentary that would require compliance with additional provisions of the Equity Research Rule. Specifically, with respect to the Equity Research Rule, a firm relying on the Proposed Safe Harbor would be required to maintain policies and procedures reasonably designed to:

- Prohibit persons engaged in investment banking activities from supervision or control of research analysts, including influence or control over research analyst compensation evaluation and determination
- Limit determination of the research department budget to senior management, excluding senior management engaged in investment banking services activities
- Prohibit compensation based upon specific investment banking services transactions or contributions to a firm's investment banking services activities.¹⁵

According to FINRA, these additional conditions with respect to the Equity Research Rule are justified given the history of improper influence by investment banking over equity research and the increased likelihood that equity research may affect stock prices.¹⁶

Proposed Safe Harbor and Existing Institutional Debt Research Exemption

The Debt Research Rule currently contains an exemption from certain of its requirements for institutional debt research. Similar to the Proposed Safe Harbor, the existing institutional debt research exemption allows members to obtain consent to provide institutional debt research by different means, depending on the proposed recipient's institutional status, without complying with the full requirements of the Debt Research Rule. According to FINRA, while the Proposed Safe Harbor is similar to the existing institutional debt research exemption, there are certain notable differences. As a result, the Debt Research Rule would retain its current institutional debt research exemption and the Proposed Safe Harbor would be added as an independent exemption.¹⁷

A significant difference between the institutional debt research exemption and the Proposed Safe Harbor is that the institutional debt research exemption applies more broadly to all debt research reports, not just debt research produced by sales and trading and principal personnel.¹⁸ In addition, the consent requirements for the institutional debt research exemption are more onerous than those required under the Proposed Safe Harbor. Specifically, the institutional debt research exemption distinguishes between institutions and the manner in which the consent is obtained: "qualified institutional buyers" (as defined in Rule 144A under the Securities Act of 1933) may agree to receive institutional debt research by negative consent; and other "institutional accounts" (as defined in FINRA Rule 4512(c)) may only agree to receive institutional debt research by affirmative written consent.¹⁹ The Proposed Safe Harbor, on the other hand, would not distinguish between larger and smaller institutional investors and would require only negative consent by a FINRA Rule 4512(c) institutional account that also satisfies the FINRA Rule 2111 institutional suitability standards.²⁰

Compliance Phase-In Period

To avoid a disruption in the receipt of desk commentary, the Proposed Safe Harbor would provide firms a transition period during which desk commentary eligible for the Proposed Safe Harbor could be sent to eligible institutional investors while firms obtain the necessary consents. Specifically, the proposal would allow a firm to send desk research to any account that meets the definition of an "institutional account" in Rule 4512(c) without negative consent for a period of up to 90 days after the effective dates of the proposed amendments to the Research Rules.²¹

Conclusion

While the Proposed Safe Harbor may represent a measure of relief for sales and trading and principal trading personnel authoring desk commentary, whether or not the Proposed Safe Harbor will achieve its

stated goal of providing firms more compliance certainty in their review of sales and trading communications remains in doubt, given that the parameters for certain key terms in the Proposed Safe Harbor are not clearly defined and that additional confusion may result from describing desk commentary as “research” and sales and trading and principal trading personnel as “research analysts” for purposes of the Proposed Safe Harbor. Perhaps, though, these issues will be addressed in the actual rule language promulgated by FINRA to implement the Proposed Safe Harbor, which language has not yet been made publicly available. Finally, although the Proposed Safe Harbor purports to provide relief from the Research Rules, the number of conditions that a firm relying on the Proposed Safe Harbor must comply with is relatively extensive. As a result, firms assessing the utility of the Proposed Safe Harbor may simply elect to make their own considered determination that desk commentary does not constitute a research report and is not subject to the Research Rules.

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Endnotes

- ¹ FINRA Regulatory Notice 17-16 (April 2017), available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-16.pdf.
- ² In a companion Regulatory Notice, FINRA also requests comment more generally on the effectiveness and efficiency of all of its rules relating to the capital formation process, including the Research Rules. Comments in respect of such notice are also due May 30, 2017. See FINRA Regulatory Notice 17-14 (April 2017), available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-14.pdf.
- ³ RN 17-16 at p. 3.
- ⁴ For ease of reference, RN 17-16 (and this *Client Alert*) uses the term “research report” to refer to either a “research report” under FINRA Rule 2241 or a “debt research report” under FINRA Rule 2242.
- ⁵ FINRA also notes, however, that in some instances FINRA has seen what effectively amounts to fundamental research coming off a trading desk. In those circumstances, FINRA states that there is no question that the communications meet the definition of a research report and should be subject to rigorous supervisory review to ensure compliance with all of the applicable provisions of the Research Rules. See RN 17-16 at p. 3.
- ⁶ While the Proposed Safe Harbor would prohibit eligible desk commentary from including the author’s own rating, price target or earnings estimate, it would not preclude referencing a rating, price target or earnings estimate in other published research, including from the firm’s own research department, or discussing the directional effect of an event on an issuer’s rating, price target or earnings. See RN 17-16 at n. 6.
- ⁷ RN 17-16 at p. 4. FINRA Rule 2111(b) requires that (1) the firm or associated person has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving equity or debt securities, as applicable; and (2) the institutional investor has affirmatively indicated that it is exercising independent judgment in evaluating the firm’s recommendations pursuant to FINRA Rule 2111.
- ⁸ RN 17-16 at p. 5.
- ⁹ RN 17-16 at p. 4.
- ¹⁰ RN 17-16 at p. 7. FINRA also notes that desk commentary that includes material non-public research information inherently would not satisfy the content limitation to be considered eligible for the Proposed Safe Harbor.
- ¹¹ RN 17-16 at n. 7.
- ¹² RN 17-16 at p. 5.
- ¹³ RN 17-16 at n. 11.
- ¹⁴ RN 17-16 at p. 7.
- ¹⁵ RN 17-16 at pp. 7-8. Note, however, that this requirement would not prohibit a firm from compensating a person in the sales and trading or principal trading department in the form of sales credits in connection with the distribution of securities in an offering, provided that the person had not published desk commentary related to those investment banking services transactions.
- ¹⁶ RN 17-16 at p. 8.
- ¹⁷ RN 17-16 at p. 9.
- ¹⁸ RN 17-16 at p. 9.
- ¹⁹ See FINRA Rule 2242(j).
- ²⁰ RN 17-16 at p. 9.
- ²¹ RN 17-16 at p. 5.