
David F. Freeman, Jr., Tim Aron, Ellen Kaye Fleishhacker, Daniel M. Hawke, Robert E. Holton, Gilbert R. Serota, and Andrew Joseph Shipe

November 2015

Background

The Financial Industry Regulatory Authority (FINRA) recently adopted new rules (particularly, Rule 2242), and changes to its existing rules (particularly, Rule 2241), that govern the creation and distribution of research reports on debt and equity securities, as well as public appearances by research analysts.¹ The changes significantly broaden the coverage of FINRA’s research rules, and reflect FINRA’s intention to focus on conflicts of interest in the securities industry.

The new debt standards will become effective on February 22, 2016. The equity rule changes will be effective December 24, 2015 (with certain portions effective in September). By those dates, FINRA members (Members) will have to implement comprehensive policies and procedures to identify and manage conflicts of interest that relate to their debt research activities, and to comply with extensive new disclosure requirements. Compliance officers, principals, and other staff of Members should understand the new rules, and how the underlying principles relate to their businesses as a whole. Highlights of the new requirements are discussed below.

Broader Scope of Coverage

In 2002, FINRA adopted rules that are intended to separate a firm’s research and investment banking functions, and to protect the integrity of research reports. Because these rules were adopted in response to perceived abuses in the markets for offerings of equity securities, they applied only to equity research reports. FINRA has noted that significant deficiencies involving inadequate supervisory procedures to manage conflicts and failure to disclose such conflicts have persisted in the production and distribution of

¹ See FINRA Regulatory Notices 15-30 and 15-31. In brief, and subject to certain exclusions, a “research report” includes any written, including any electronic, non-internal communication, that includes an analysis of a security or an issuer and that provides information reasonably sufficient upon which to base an investment decision. See FINRA Rules 2241(a)(11); 2242(a)(3). Securities and Exchange Commission (SEC) regulations governing research reports can be found at Regulation AC (17 CFR § 242.500, et seq.). Additional background and guidance with respect to research production and conflict management can be found on the section of the SEC website describing the 2002 Global Research Analyst Settlement (https://www.sec.gov/spotlight/globalsettlement.htm).
debt research reports, and that a 2012 report by the United States Government Accountability Office concluded that “until FINRA adopts a fixed-income research rule, investors continue to face a potential risk.”

Now, FINRA has significantly expanded the coverage of its research rules to include “debt research,” broadly defined. In fact, while the title of new FINRA Rule 2242 refers to “debt research,” it applies to all types of securities other than equities, municipal securities, security-based swaps, and US Treasuries. New Rule 2242 can be understood as a catch-all that applies not only to conventional bonds, but to notes, trust certificates, non-equity interests in asset-backed issues, and other types of securities.

Identifying and Managing Conflicts of Interest

The new debt research rule (Rule 2242) and the changes to the existing equity research rule (Rule 2241) are focused on a Member firm’s awareness and proactive management of the conflicts of interest created by its overall structures and activities, including trading operations, and not just those created by its investment banking business.

Both the new debt and revised equity research rules require Members to implement written policies and procedures reasonably designed to identify and manage conflicts of interest related to the preparation, content, and distribution of research reports, as well as public appearances by research analysts. The written policies and procedures must also address interactions between research analysts and persons outside of the research department, including investment bankers, trading personnel, and subject companies.

The requirements for policies and procedures are quite detailed, and extend deeply into aspects of the governance and operations of the Member. As one example, a Member’s written policies and procedures must limit determination of the firm’s equity research department budget to senior management, excluding senior managers engaged in investment banking activities. For the debt research department,

---

2 Securities Research, Additional Actions Could Improve Regulatory Oversight of Analyst Conflicts of Interest (January 2012).
3 Convertible debt securities are treated as equity securities and are covered by FINRA Rule 2241. See Rule 2241(a)(2) (incorporating definition of “equity security” in Section 3(a)(11) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)(11))).
4 Rule 2241(b)(2).
the restriction is even broader: the determination of the budget must be limited to senior management, excluding senior managers engaged in investment banking services or principal trading activities, and must be made without regard to specific revenues or results derived from investment banking. This is the first time that FINRA has explicitly subjected a Member’s budgeting processes to its rulebook.

Other matters that a Member’s research policies and procedures must address include restrictions on reviews of research reports by non-research personnel and subject companies, control of the drafting process when non-research personnel and subject companies are asked to verify facts, information barriers between research analysts and investment banking, sales, and trading personnel, responsibilities for determining the coverage of issuers, and processes for determining the compensation of research personnel. In addition, the new and revised debt and equity research rules require Members to implement written policies and procedures reasonably designed to prevent research from being distributed selectively to internal trading personnel or particular customers before other customers that are entitled to receive it. Due to the detailed requirements of these restrictions, Members must take care in drafting new policies and procedures, and in reviewing their current operations for compliance.

Disclosure Requirements

Under the new and revised rules, debt and equity research reports must include numerous disclosures. Both types of reports must include explanations of ratings systems, the percentage of rated issuers that receive favorable and unfavorable ratings, information about investment banking services provided to rated issuers, and other related information. As a new requirement, both sets of rules will mandate disclosure whenever a research analyst, or a member of the analyst’s household, has a financial interest in the debt or equity securities of a company that is the subject of a research report or public appearance, and the nature of any such interest (including any options, rights, warrants, futures, and long or short positions).

---

5 Revenues and results of the firm as a whole, however, may be considered in determining the debt research department budget and allocation of expenses. Rule 2242(b)(2)(E).

6 Supplementary materials to the rules recognize that firms often provide different types of research to different customers. Therefore, a Member will not violate this requirement if, in brief, research products are not differentiated based on the timing of receipt, and it discloses its research dissemination practices to all customers that receive research products. Rule 2241, Supplementary Material.07; Rule 2242, Supplementary Material.06.
positions).\textsuperscript{7} Exceptions from disclosure requirements apply when disclosure would reveal material non-public information regarding specific potential future investment banking transactions.\textsuperscript{8}

**Exemption for Debt Research Reports Provided to Institutional Investors**

The new rules include an exemption with respect to debt research reports that are provided only to certain institutional investors.\textsuperscript{9} No parallel exemption has been created for equity research reports. For the exemption to apply, the Member must implement policies and procedures to ensure that only certain institutional investors receive the debt research reports. The exemption is unavailable if there is reason to believe that a report will be distributed to retail investors. In brief, the exemption permits distribution of research reports that are subject to less stringent requirements to either of the following:

- “Institutional accounts” as defined in FINRA Rule 4512(c).\textsuperscript{10} Such investors must affirmatively elect in writing to receive institutional debt research.\textsuperscript{11}

- “Qualified institutional buyers” (QIBs) as defined in Rule 144A under the Securities Act of 1933.\textsuperscript{12} A QIB’s consent may be given affirmatively in writing. However, a Member may also rely on a QIB’s negative consent where (1) the Member has a reasonable basis to believe that the QIB is capable of evaluating investment risks independently, both in general and as to particular transactions and strategies involving debt securities; and (2) the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the Member’s

---

\textsuperscript{7} Rules 2241(c)(4), (d); 2242(c), (d).

\textsuperscript{8} Rules 2241(c)(5)(d)(2); 2242(c)(5)(d)(2).

\textsuperscript{9} Rule 2242(j).

\textsuperscript{10} Rule 4512(c) defines an “institutional account” to mean the account of: (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC or with a state securities commission; or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least US$50 million.

\textsuperscript{11} Rule 2242(j)(1)(B). As a phase-in measure, the rule allows firms to send institutional debt research to any Rule 4512(c) account, except a natural person, without affirmative or negative consent until July 16, 2016. Natural persons that qualify as an “institutional account” must provide affirmative consent to receive institutional debt research during the transition period and thereafter.

\textsuperscript{12} 17 CFR § 230.144A.
recommendations and such affirmation is broad enough to encompass transactions in debt securities.

Any debt research that is distributed in reliance on this exemption must bear, on its first page, a prominent “health warning” that states:

This document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors.

Where applicable, the health warning must also include either or both of the following statements:

The views expressed in this report may differ from the views offered in [Firm's] debt research reports prepared for retail investors.

This report may not be independent of [Firm's] proprietary interests. [Firm] trades the securities covered in this report for its own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to the recommendation(s) offered in this report.

A Member that distributes debt research to institutional investors pursuant to this exemption would not have to implement written policies and procedures with respect to such research in the following areas, which are otherwise required:

- Restrictions or prohibitions on prepublication review of debt research by principal trading and sales and trading personnel or others outside the research department (other than investment banking personnel, who may not be permitted to take part in such reviews);

- Restrictions on input into coverage decisions by investment banking, principal trading, and sales and trading personnel;

- Limiting supervision of debt research analysts to persons not engaged in investment banking, principal trading, or sales and trading activities;
• Limiting determination of the debt research department’s budget to senior management not engaged in investment banking or principal trading activities and without regard to specific revenues derived from investment banking;

• Determination of debt research analyst compensation;

• Restrictions or limits on debt research analyst account trading; and

• Information barriers or safeguards to protect debt research analysts from review or oversight by investment banking, sales, and trading or principal trading personnel (but the Member must have policies and procedures to guard against such persons pressuring analysts).

Nonetheless, significant requirements would still apply to institutional debt research. Members must prohibit debt research analysts from participating in the solicitation of investment banking services transactions, road shows, and the like. Members must also implement policies and procedures for the management of conflicts with respect to debt research reports in general, and FINRA rules that prohibit retaliation against debt research analysts and promises of favorable debt research to companies still apply.

**Distributing Third-Party Debt Research Reports**

Many FINRA Members distribute research reports prepared by other firms, including affiliates. With respect to such third-party research, the new debt research rules and the revised equity research rules generally track each other. Thus, both sets of rules prohibit a Member from distributing third-party research if it knows or has reason to know that the research is not objective or reliable.

A Member must establish, maintain, and enforce written policies and procedures reasonably designed to ensure that any non-independent third-party research report it distributes contains no untrue statement of material fact and is otherwise not false or misleading. For these purposes, a Member must review non-independent third-party research in order to ensure that it contains no untrue or misleading statements

---

13 Research prepared by non-US affiliates may be distributed through US broker-dealers pursuant to certain provisions of SEC Rule 15a-6 (17 CFR § 240.15a-6).
that should be known from reading the report, or that is known based on other information possessed by the Member.

On the other hand, a Member will not be required to review independent third-party research prior to distribution. Research is “independent” if the person producing the report (a) has no affiliation or business or contractual relationship with the distributing Member or the Member’s affiliates that is reasonably likely to inform the content of its research reports; and (b) makes content determinations without any input from the distributing Member or that Member’s affiliates.14

Third-party debt research reports (from both affiliated and independent third parties) must be accompanied by (or provide an internet address for) disclosures of material conflicts of interest, including but not limited to information regarding investment banking services provided to the subject company by the Member or any of its affiliates. Members must also ensure that third-party debt research reports are clearly labeled as such and that there is no confusion as to the person or entity that prepared the reports.15

Conclusion

The requirements discussed above are only highlights from FINRA’s new and revised research rules. The new standards are quite extensive and detailed. Members that produce and distribute securities research, or whose analysts make public appearances, should take time to carefully review all of the new standards, assess their current operations, and implement policies and procedures to ensure compliance. Because the overall purpose of the research rules is to eliminate or reduce conflicts of interest, a Member’s review of its operations should comprehensively examine the relationships between research personnel and other personnel within the firm, including those that perform investment banking, sales, trading, and supervisory functions. Members must candidly assess such relationships and the potential conflicts that they raise in order to design compliance programs that will ensure compliance with FINRA’s standards.

14 Rules 2241(a)(3); 2242(a)(6).

15 Rules 2241(h); 2242(g).
If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

David F. Freeman, Jr.
+1 202.942.
David.Freeman@aporter.com

Tim Aron
+44 (0)20 7786 6144
Tim.Aron@aporter.com

Ellen Kaye Fleishhacker
+1 415.471.3152
Ellen.Fleishhacker@aporter.com

Daniel M. Hawke
+1 202.942.6743
Daniel.Hawke@aporter.com

Robert E. Holton
+1 212.715.1137
Robert.Holton@aporter.com

Gilbert R. Serota
+1 415.471.3170
Gilbert.Serota@aporter.com

Andrew Joseph Shipe
+1 202.942.5049
Andrew.Shipe@aporter.com

© 2015 Arnold & Porter LLP. This Advisory is intended to be a general summary of the law and does not constitute legal advice. You should consult with counsel to determine applicable legal requirements in a specific fact situation.