

Chapman Client Alert

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Current Issues Relevant to Our Clients

FINRA Revises New Debt Research Rule — Compliance Date Remains July 16, 2016

The Financial Industry Regulatory Authority, Inc. (“*FINRA*”) recently filed changes to new FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) with the Securities and Exchange Commission (“*SEC*”). The rule is still new and FINRA has delayed implementation several times. The recent rule changes are intended to clarify:

- the consent requirement for institutional debt research reports distributed to non-U.S. investors by non-U.S. affiliates of FINRA member firms;
- the consent requirement for institutional debt research reports distributed for informational purposes unrelated to investing in debt securities;
- the scope of the institutional debt research report exemption when distributing third-party debt research reports to eligible institutional investors; and
- the disclosure requirements for debt research analysts in public appearances.

The implementation date for the new rule, including the recent changes, is July 16, 2016. The SEC notice related to the new changes is available [here](#). For more information on FINRA Rule 2242, please see our Client Alerts available [here](#), [here](#) and [here](#).

[Consent Requirement for Institutional Debt Research Reports Distributed to Non-U.S. Investors by Non-U.S. Affiliates of Member Firms](#)

Rule 2242(j) exempts debt research reports distributed solely to eligible institutional investors from most of the provisions regarding supervision, coverage determinations, budget and compensation determinations and all of the disclosure requirements applicable to debt research reports distributed to retail investors. The rule specifies a “health warning” that must be prominently disclosed on the first page of any institutional debt research report and requires either negative or affirmative written consent for eligible institutional investors to receive institutional debt research reports pursuant to the exemption.

The recent rule change clarifies that a non-U.S. affiliate of a FINRA member firm is permitted to distribute institutional debt research reports (including globally branded research reports) of the FINRA member firm to a non-U.S. institutional investor customer without receiving the consent required under the exemption if:

- the non-U.S. institutional investor is not a customer of the FINRA member firm;
- the non-U.S. institutional investor is a customer of the non-U.S. affiliate distributing the report; and

- the non-U.S. affiliate of the FINRA member firm has a reasonable basis to believe that the customer meets the definition of an institutional account.

[Consent Requirement for Institutional Debt Research Reports Distributed for Informational Purposes](#)

The requirements of Rule 2242 assume that debt research reports are distributed to investors that may base their investment decisions on the debt research reports or incorporate elements of the debt research reports in their investment decisions. FINRA believes that it is appropriate to permit FINRA members to distribute institutional debt research reports to persons for specific informational purposes unrelated to investing in debt securities.

The rule changes would permit a FINRA member to distribute institutional debt research reports to specified persons for informational purposes unrelated to investing in debt securities provided that:

- the FINRA member does not distribute the reports prior to the publication;
- the FINRA member has disclosed that the member may provide debt research reports to institutional investors that

are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors; and

- the FINRA member has disclosed that the debt research reports would be provided only for informational purposes and not for the purpose of making an investment decision related to debt securities.

The rule changes also set forth circumstances where institutional debt research reports may be distributed for informational purposes unrelated to investing in debt research including to:

- regulators for regulatory purposes;
- academics for academic purposes;
- issuers for the purpose of enhancing knowledge of their industry, competitors and market and economic factors; and
- media organizations for news gathering purposes.

The rule changes also provide that if the person receiving such institutional debt research reports does not contact the FINRA member to request that such reports not be provided, that the FINRA member can reasonably conclude that the person has consented to receiving the institutional debt research reports according to the terms above.

Distribution of Third-Party Institutional Debt Research Reports

FINRA has indicated that the institutional debt research exemption in Rule 2242(j) applies to the content and disclosure requirements for third-party debt research reports.

The rule changes amend Rule 2242 to clarify the requirements applicable to the distribution of third-party debt research reports pursuant to the institutional debt research exemption. The rule changes clarify that a FINRA member that distributes third-party debt research reports to institutional investors pursuant to the exemption must establish, maintain and enforce written policies and procedures reasonably designed to comply with certain provisions of Rule 2242(g). The changes require application of the Rule 2242(g) requirements to the distribution of third-party institutional debt research reports as follows:

- Rule 2242(g)(1) would apply. The provision prohibits distribution of third-party institutional debt research reports if a firm knows or has reason to know such research is not objective or reliable.

- Rule 2242(g)(2) would apply except with respect to independent third-party debt research reports (pursuant to the Rule 2242(g)(4) exemption). The provision requires policies and procedures reasonably designed to ensure that the third-party research contains no untrue statement of material fact and is otherwise not false or misleading.
- Rule 2242(g)(3) would not apply. The provision requires inclusion of certain conflict of interest disclosures. Instead of being required to comply with this provision, the rule changes require a modified “health warning” described below.
- Rule 2242(g)(4)’s exemption from Rule 2242(g)(2) would be available.
- Rule 2242(g)(5)’s exemption from Rule 2242(g)(3) would not be available (and would not be necessary since Rule 2242(g)(3) does not apply to independent third-party institutional debt research reports).
- Rule 2242(g)(6) would apply. The provision requires firms to ensure that third-party debt research reports are clearly labeled as third-party debt research and that there is no confusion for the recipient as to the person or entity that prepared the debt research report.

The rule change would also amend Rule 2242 to clarify that third-party institutional debt research reports must disclose prominently on the first page of the report that:

- “this document is intended for institutional investors and is not subject to all of the independence and disclosure standards to debt research reports prepared for retail investors” and
- if applicable, that “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.”

Disclosure Requirements for Debt Research Analysts in Public Appearances

Rule 2242(d) requires certain disclosures from debt research analysts in public appearances including debt research analysts that only prepare debt research reports pursuant to the institutional debt research exemptions. In the FINRA Research Rules Frequently Asked Questions, FINRA indicated that it would be inconsistent with the rationale of the institutional exemption to allow debt research analysts to make public appearances before an audience that could include retail investors. FINRA is proposing changes to clarify that the

public appearance disclosure requirements do not apply where attendance is limited to institutional investors eligible to receive institutional debt research reports.

The rule changes would require a member to maintain records to demonstrate that attendance at a public appearance was limited to institutional investors eligible to receive institutional debt research for at least three years from the date of the public appearance. The disclosure requirements would still apply where attendance at the public appearance was not limited to institutional investors eligible to receive institutional debt research reports.

What's Next?

While the rule changes are immediately effective, you can submit comments to the SEC on the rule changes by submitting a hard copy, by using the SEC's internet comment

form link available at <https://www.sec.gov/rules/sro.shtml> (referring to File Number SR-FINRA-2016-017), or by sending an e-mail to rule-comments@sec.gov (and including File Number SR-FINRA-2016-017 on the subject line). Comments should be submitted within 21 days of the proposal being published in the Federal Register. The implementation date of new Rule 2242 and the recent changes is July 16, 2016. As firms prepare for the July 16, 2016 implementation date, they should review their policies and procedures relating to debt research reports in light of the rule changes in addition to the other new requirements of Rule 2242.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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