

FINRA Proposes Debt Security Research Obligations

The Financial Industry Regulatory Authority, Inc. (“FINRA”) recently issued a concept proposal to apply objectivity safeguards and disclosure requirements to the publication and distribution of debt security research reports. Current FINRA rules related to research reports apply only to equity securities. FINRA is not currently proposing a specific new rule but rather seeking comment on a general concept proposal before definitive rulemaking. The FINRA Notice proposing these rule changes is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123296.pdf>. You may submit comments on the proposal to FINRA through April 25, 2011, by hard copy or by emailing comments to pubcom@finra.org.

Summary

In 2006, FINRA and the New York Stock Exchange published findings of examinations of member firms conducted to assess how firms addressed conflicts of interest with respect to fixed income research (see NASD Notice to Members 06-36). Those findings, along with principles published by the Bond Market Association, have provided industry guidance regarding debt security research; however, FINRA now believes that rulemaking is appropriate in light of increased retail investment in complex debt securities and allegations of conflicts of interest in the sale of certain debt securities. Subject to certain exceptions, FINRA's current research rules apply only to equity securities. FINRA proposes to apply provisions of FINRA's equity research rules to debt research, but to bifurcate retail investors and institutional investors. As a result, the vast majority of protections currently covering equity research would be extended to debt research distributed to retail investors. Debt research distributed solely to institutional investors, however, would be more general (although an institutional investor would be allowed to choose to receive the full protections accorded retail debt research). The proposal would also govern permissible communications between debt research analysts and sales and trading personnel.

Key Definitions

Under the proposal, a “debt security” would be any security other than an equity security, treasury security, or municipal security, as those terms are defined in the relevant federal securities laws. A “debt research report” would closely follow the current definition of a research report in NASD Rule 2711 to include a communication that includes an analysis of securities and provides information reasonably sufficient upon which to base an investment decision and would be subject to the same exceptions in that rule. The definition of “institutional investor” would be the same as “institutional account” under FINRA Rule 2111 (Suitability), and would generally cover: (i) banks, savings and loans, insurance companies, or registered investment companies; (ii) investment advisers registered either with the SEC or with a state securities commission; or (c) any other entity with total assets of at least \$50 million.

Retail Debt Research Standards

Under the proposal, most of the existing standards in NASD Rule 2711 would apply to retail debt research. However, unlike the equity research rules, the proposed debt research rules would also address conflicts between debt research and sales and trading personnel. As a result, the proposal would :

- Require member firms to have policies and procedures designed to identify and effectively manage conflicts of interest related to: (i) the preparation, content, and distribution of debt research reports; (ii) public appearances by debt research analysts; and (iii) the interaction between debt research analysts and those outside of the research department (including investment banking department personnel, sales and trading department personnel, subject companies, and customers);
- Prohibit prepublication review, clearance, or approval of debt research by a firm's investment banking, sales, and trading personnel and generally restrict (or prohibit) prepublication review, clearance, or approval by a subject company or by firm personnel who are not directly responsible for the preparation, content, and distribution of debt research;
- Prohibit input by investment banking, sales, and trading into the determination of the research department budget;
- Limit the supervision and compensatory evaluation of debt analysts to persons not engaged in investment banking services or sales and trading;
- Require the review and approval of debt analyst compensation by the same type of committee required to review equity analyst compensation and prohibit compensation based on specific investment banking or sales and trading transactions or contributions to the firm's investment banking or sales and trading activities;
- Restrict or limit debt analyst account trading in the securities, derivatives, and funds related to the securities covered by the analyst;
- Prohibit promises of favorable debt research coverage;
- Prohibit retaliation against debt analysts by investment banking personnel or other employees as the result of an adverse, negative, or otherwise unfavorable research report or public appearance;
- Restrict or limit activities by debt analysts that can reasonably be expected to compromise objectivity; and
- Prohibit investment banking from directing debt analysts to engage in sales or marketing efforts or any communication with a customer about an investment banking services transaction.

The proposal would also require disclosure of personal and firm financial interests, the receipt of investment banking services compensation, and the meaning of each rating employed in any rating system used by the firm in the research report. If a firm acts as a market maker in the security being traded, the proposal would require disclosure if the firm generally engages in principal trading of that security. In addition, supervisory review and disclosure obligations applicable to the distribution of third-party equity research would similarly apply to third-party retail debt research.

Institutional Debt Research Standards

The proposal would exempt debt research disseminated solely to institutional investors from most of the retail research standards and obligations noted above. As compared to retail investors, FINRA believes that institutional investors

place more value on timely analysis, are more fully aware of potential conflicts between a firm's recommendations and trading interests, and are better capable of exercising independent judgment and incorporating research into their own analysis when reaching pricing decisions. As a result, FINRA believes that institutional investors trading in debt securities interact with broker-dealers more as counterparties than as customers. Nevertheless, firms availing themselves of this institution-only exemption would be required to provide on the first page of a debt research report a prominent "health warning" disclosure that includes that:

- The research is intended for institutional investors only and is not subject to all of the independence and disclosure standards applicable to research provided to retail investors;
- If applicable, that the firm trades the securities covered in the research for its own account and on behalf of certain clients and such trading interests may be contrary to the recommendations offered in the research, and the research may not be independent of the firm's proprietary interests; and
- If applicable, that the research may be inconsistent with recommendations offered in the firm's research that is disseminated to retail investors.

FINRA notes that this approach would alleviate the need for a firm to determine whether a particular communication sent only to institutional investors meets the definition of a debt research report, but firms that utilize this institutional-only exemption would be required to clearly distinguish such research from debt research disseminated to retail investors. However, FINRA proposes that certain of the retail safeguards would apply to institutional-only research, including prohibitions or restrictions on:

- Promises of favorable research;
- Debt research analyst involvement in pitches, road shows, and other marketing;
- Certain three-way meetings about an investment banking services transaction that involve debt analysts and customers where either investment banking personnel or issuer management are present;
- Input into research coverage by investment banking personnel;
- Retaliation against debt research analysts for unfavorable research;
- Review of research by the subject company (beyond fact-checking) or investment banking personnel; and
- Investment banking directing debt research analysts to engage in sales or marketing efforts or any communication with a customer about an investment banking services transaction.

Communication Firewalls

FINRA believes that the unique characteristics of the debt market, such as limited last sale transparency, necessitate certain communications between analysts and traders in order for them to perform their primary functions. As a result, the proposal outlines the permissible interactions between debt analysts and sales and trading personnel, including:

- Sales and trading personnel seeking information from debt analysts regarding the creditworthiness of an issuer (and other information that is related to the price/performance of the security), provided that the information is consistent with the analyst's published research;

- Debt analysts seeking information from sales and trading personnel regarding a particular instrument, current prices, spreads, liquidity, and similar market information relevant to the analyst's valuation of a particular debt security; and
- Sales and trading personnel providing input to research management regarding debt research coverage decisions, provided that final coverage decisions are made by research management.

The proposal would prohibit communications that involve sales and trading personnel attempting to influence a debt analyst's opinion or views for the purpose of benefiting the trading position of the firm, a customer, or a class of customers. In addition, the proposal would prohibit communications that involve debt analysts identifying or recommending specific potential trading transactions to sales and trading personnel that are not contained in such debt analyst's currently published reports disclosing the timing of or material investment conclusions in a pending debt research report or otherwise having any communication for the purpose of determining the profile of a customer to whom research should be directed.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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