

FINRA Proposes Revised Debt Security Research Rule

The Financial Industry Regulatory Authority, Inc. (“FINRA”) recently issued a revised rule 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 originally published a concept proposal on debt research in March 2011. For information on the original concept proposal and background for the rule proposal, please see our March 2011 Client Alert available at <http://www.chapman.com/media/news/media.977.pdf>. FINRA now seeks comment on a revised rule proposal as described below. The FINRA Regulatory Notice proposing the rule changes is available at <http://www.finra.org/Industry/Regulation/Notices/2012/P125615>.

Key Definitions

Debt Security. The proposed rule defines “debt security” to include any “security” other than a US Treasury security (as defined in FINRA Rule 6710) or an equity security, municipal security, or security-based swap (as defined under the Securities Exchange Act of 1934). The original proposal did not include security-based swaps, but FINRA added this term due to the evolving nature of swap regulation. FINRA rejected several requests to exclude non-equity securities not traditionally considered to be “debt”, as well as agency securities and certain foreign sovereign debt. As a result, the rule would cover agency securities such as Fannie Mae and Freddie Mac securities because these securities are not covered in the FINRA Rule 6710 definition of “US Treasury Security”.

Debt Research Report. The definition of “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. The definition would also include the same exceptions included in NASD Rule 2711. Fearing loopholes, FINRA rejected a request to exclude “trader commentary” and other analytical communication produced by non-research personnel.

Institutional Investor. The proposed rule would generally not apply to debt research reports disseminated only to “institutional investors”, subject to a very significant qualification. The revised proposal includes the same definition of “institutional investor” as the original proposal with one significant side issue. The proposed rule defines “institutional investor” to mean any person described in FINRA Rule 4512(c) (defining “institutional account”). This includes (1) a bank, savings and loan association, insurance company, or registered investment company; (2) a federally- or state-registered investment adviser; and (3) any other person with total assets of at least \$50 million (whether a natural person, corporation, partnership, trust, or otherwise). The original proposal would have permitted institutional investors to elect to be treated as a retail investor for the purposes of these rules—effectively an “opt-out” right. The revised proposal effectively retains this concept but changes it an “opt-in” right. Accordingly, the revised proposal treats an otherwise eligible institutional investor as a retail investor unless the investor affirmatively notifies the member firm in writing that it wishes to forego treatment as a retail investor. FINRA believes that investors who want the full protections of the rules should not be required to take additional steps to receive those protections. As a result, the proposed rule treats all investors as retail investors as a default, and firms would need to obtain affirmative written consent from institutions to have reports sent to such investors treated as being disseminated only to institutional investors.

Required Policies to Identify and Management Conflicts of Interests

The revised proposal generally maintains the structural safeguards contemplated by the original proposal. The revised proposal would require member firms to have policies and procedures designed to identify and effectively manage conflicts of interest related to (1) the preparation, content, and distribution of debt research reports; (2) public appearances by debt research analysts; and (3) 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). At a minimum, these policies and procedures would need to:

- prohibit prepublication review/approval of research reports by investment banking personnel, principal trading personnel, and sales and trading personnel, as well as others not directly responsible for the preparation, content, and distribution of research reports, other than legal and compliance personnel;
- restrict or limit activities by research analysts that could compromise their objectivity, including prohibiting participation in investment banking solicitations and marketing on behalf of issuers;
- prohibit investment banking personnel from directing a research analyst to engage in investment banking sales efforts or communications;
- restrict or limit input by investment banking, sales and trading, and principal trading personnel into debt research coverage decisions; and
- prohibit prepublication review of a research report by a subject company for purposes other than verification of facts.

The proposed rule would also require that FINRA members implement policies and procedures reasonably designed to promote objective and reliable research reflecting truly-held opinions and prevent the use of research reports or analysts to manipulate or condition the market or favor the interests of the member or a current or prospective customer or class of customers. At a minimum, these policies and procedures would need to:

- prohibit supervision of a research analyst by persons involved with investment banking transactions,

principal trading activities, or sales and trading (most such persons also must be precluded from input into analyst compensation);

- limit determination of the debt research department budget to senior management, other than persons engaged in investment banking services or principal trading activities, and without regard to specific revenues or results derived from investment banking or principal trading activities;
- prohibit compensation based on specific investment banking or trading transactions or contributions to a firm's investment banking or principal trading activities;
- require that the research analyst compensation be reviewed and approved at least annually by a committee (excluding investment banking and principal trading personnel) that reports to the firm's board of directors and that considers certain specified items;
- establish information barriers or other safeguards to ensure that research analysts are insulated from the review, pressure, or oversight by persons engaged in investment banking services, principal trading activities, and others who might be biased in their judgment or supervision;
- restrict or limit research analyst account trading in securities, any derivatives of such securities, and any fund whose performance is materially dependent upon the performance of securities covered by the debt research analyst;
- prohibit retaliation or threats of retaliation against debt analysts by any employee of the firm for publishing research or making a public appearance that may negatively impact a current or prospective business interest; and
- prohibit promises of favorable debt research coverage.

Debt Research Reports Content and Disclosure

The revised proposal would require firms to ensure that any purported facts and any recommendations or ratings in a debt research report have a reasonable basis. Recommendations or ratings would need to be

accompanied by clear explanations of any valuation method used and fair presentations of the risks involved. The proposed rule would require that if a ratings system is employed, each debt research report must clearly define the meaning of each rating, including the time horizon or any benchmark on which the rating is based. Moreover, the definition of ratings would need to be consistent with their plain meanings. As with the equity research rules, a firm would need to include in each debt research report that includes a rating the percentage of all securities rated by the firm that it would assign a “buy,” “hold,” or “sell” rating, and further indicate the percentage of subject companies in each of those categories for which the firm has provided investment banking services within the previous 12 months. In most circumstances, such information would need to be current as of the end of the most recent calendar quarter. If a debt security has been rated for at least one year, the rule would also require that a report include all previously assigned ratings and the corresponding dates. Unlike the equity research rules, the revised proposal does not require those ratings to be plotted on a price chart.

The revised proposal would require firms to disclose in debt research reports all conflicts that could reasonably influence objectivity and that are known (or should have been known) by the firm or debt research analyst on the date of publication or distribution of the report. The proposed rule sets forth a number of required disclosure items, including if the research analyst or a household member has a financial interest in the debt or equity securities of the subject company and the nature of such financial interest, if the member firm has been involved in investment banking or other activities with respect to the subject company in the preceding 12 months, and if the member firm trades in the subject debt securities as principal, among other things. The original proposal would have required firms to disclose if the firm or its affiliates maintain a significant financial interest in the subject company. In response to comments, the revised proposal instead requires disclosure of debt or equity positions in the subject company only where the positions amount to a material conflict of interest that the analyst (or a person with ability to influence the content of the report) knows or has reason to know at the time of publication or distribution of the debt research report. The revised proposal also provides that disclosures need not be made if they would reveal material non-public information regarding specific potential investment banking transactions of the subject company.

Public Appearances

The revised proposal closely parallels the equity research public appearance rules, requiring disclosure:

- of the analyst and his or her household member’s financial interest in the subject company;
- if the analyst knows or has reason to know that the firm or any affiliate received compensation from the subject company in the previous 12 months;
- if the debt analyst received compensation from the subject company in the previous 12 months;
- if the analyst knows or has reason to know that the subject company has been a client in the previous 12 months and the nature of services provided; and
- of any other material conflict of interest of the debt research analyst or firm that the analyst knows or has reason to know at the time of the public appearance.

Institutional Investor Debt Research

The revised proposal closely mirrors the original proposal with regards to institutional debt research standards. The proposed rule generally does not apply research distributed solely to eligible institutional investors. A member would, however, still be required to establish, maintain, and enforce certain policies and procedures, including policies and procedures reasonably designed to identify and effectively manage conflicts of interest. In addition, debt research would need to include certain disclosures prominently on the first page designed to identify the report as being intended only for institutional investors and address other disclosure issues.

Communication Firewalls

The original proposal identified certain permissible and prohibited communications between analysts and traders. Many commenters suggested that sales and trading personnel should be able to communicate customer interests to analysts and that analysts should not be precluded from generating trade ideas and strategies that were not contained in currently published research. In response, the revised proposal clarifies in supplementary

material the permissible interactions between such personnel, specifically that:

- sales and trading and principal trading personnel may communicate customers' interests to research personnel, so long as debt research analysts do not respond by publishing research that is intended to benefit any trading position of the firm, a customer, or a class of customers and
- debt research analysts may provide customized analysis and recommendations or trade ideas to sales and trading and principal trading personnel and customers, provided that any such communications are not inconsistent with the analyst's currently published or pending research and that any subsequent research is not for the purpose of benefiting any firm or customer positions.

The revised proposal maintains the general prohibition against traders attempting to influence an analyst's opinions or views for the purpose of benefiting the trading position of the firm or a customer. It further prohibits analysts from identifying or recommending specific potential transactions to traders that are inconsistent with the analyst's currently published debt research reports and from disclosing the timing of, or material investment conclusions in, a pending debt research report.

Termination of Coverage

The original proposal would have required a firm to promptly notify its customers if it intends to terminate coverage in a debt security and include with the notice a final research report. If it were impracticable to provide such final report, a firm would have been required to disclose to customers its reason for terminating coverage. FINRA now believes the termination of coverage provision in the debt context would be overly burdensome to firms relative to its investor protection value and eliminated the provision from the revised proposal.

Distributing Member and Third-Party Reports

The revised proposal requires that firms do not selectively distribute debt research reports to traders or particular customers in advance of other customers that are entitled to receive the report. Supplementary material would explain that this does not preclude offering different

research products to different customers as long as the product is not differentiated only by the timing of recommendations, ratings, or other potential market-moving information. The revised proposal generally incorporates the current standards for third-party equity research, including the distinction between independent and non-independent third-party research. The rule would require that firms have procedures to ensure that non-independent, third-party debt research contains no untrue statement of material fact and is not otherwise false or misleading. The revised proposal further requires that firms ensure that third-party research is clearly labeled as such, is reliable and objective, and discloses any material conflict of interest that can reasonably be expected to have influenced the choice of third-party research provider or the subject company of a third-party debt research report.

Exemption for Members With Limited Investment Banking Activity

The revised rule would exempt members with limited investment banking activity from certain provisions of the rule. These members include firms that over the previous three years have participated in, on average, 10 or fewer investment banking services transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions. This is the same metric used for an exemption from certain provisions of the equity research rules.

Submitting Comments

You may submit comments on the proposal to FINRA through April 2, 2012, by hard copy or by e-mailing comments to pubcom@finra.org.

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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