

# Memorandum

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## FINRA Proposes Rule Changes to Address Research Analyst Conflicts of Interest

December 29, 2014

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On November 14, 2014, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed Rule change to adopt NASD Rule 2711 (Research Analysts and Research Reports) as new FINRA Rule 2241, with several modifications to the existing Rule.<sup>1</sup> The Rule change also would apply to the corresponding New York Stock Exchange Rule 472. While the proposed Rule change retains the core provisions of the current Rules, it broadens the obligations on FINRA members to identify and manage research-related conflicts of interest and clarifies the applicability of the existing Rules. In addition, the proposed Rule change significantly shortens the blackout periods during which FINRA members may not publish or distribute equity research reports or make public appearances relating to the issuer, and completely eliminates the blackout periods before and after the expiration, waiver or termination of a lock-up agreement.

### Conflicts of Interest

Existing NASD Rule 2711 generally requires disclosure by equity research analysts of conflicts of interest in equity research reports that they publish and public appearances that they attend. The Rule also prohibits certain conduct that could result in a conflict of interest, such as the involvement of investment banking personnel in the preparation of research reports, requires separation between research and investment banking, proscribes conduct that could compromise a research analyst’s objectivity, such as allowing investment banking personnel to have supervision or control over research analysts, and requires specific disclosures in equity research reports and public appearances by research analysts.<sup>2</sup>

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<sup>1</sup> SEC Release No. 34-73622, File No. SR-FINRA-2014-047, available at <http://www.sec.gov/rules/sro/finra/2014/34-73622.pdf>.

<sup>2</sup> In 2003, federal and state authorities and self-regulatory organizations reached a settlement with 10 FINRA member firms to resolve allegations of misconduct involving conflicts of interest between their research analysts and investment bankers. In December 2014, FINRA reached another settlement with 10

Proposed FINRA Rule 2241 builds on the existing Rule and requires FINRA members to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to: (1) the preparation, content and distribution of research reports; (2) public appearances by research analysts; and (3) the interaction between research analysts and those outside of the research department, including investment banking and sales and trading personnel, the subject companies and customers.<sup>3</sup> The required policies and procedures must address at a minimum the following areas:

- *Quiet Periods.* The proposed Rule requires FINRA members to comply with quiet periods with respect to equity offerings, during which the member must not publish or otherwise distribute research reports, and research analysts must not make public appearances relating to an issuer. The proposal reduces the current 40-day quiet period for initial public offerings (“IPOs”) to a minimum of 10 days after the completion of the offering for any member that participated as an underwriter or dealer, and reduces the 10-day secondary offering quiet period to three days after the completion of the offering for any member that participated as a manager or co-manager in the secondary offering. The proposal also eliminates the current quiet period of 15 days before and after the expiration, waiver or termination of a lock-up agreement.<sup>4</sup> As a result, issuers and underwriters would no longer need to include “booster-shot” provisions in lock-up agreements. This change will bring consistency with the quiet period rules applicable to emerging growth companies (“EGCs”), with the effect of greatly simplifying the mechanics of planning for a secondary offering in connection with the waiver of a lock-up.
- *Pre-publication Review.* The proposed Rule maintains the current prohibition on pre-publication review of research reports by investment banking personnel, but eliminates the exception that permits such review for the purpose of verifying the factual accuracy of information in a research report.
- *Coverage Decision.* The proposed Rule requires that investment banking personnel have only limited input in research coverage decisions. Investment banking personnel may convey customer interest to the research department, but final decisions regarding coverage must be made by the research department.
- *Supervision and Control of Research Analysts.* Under the proposed Rule, persons engaged in investment banking activities are prohibited from supervising or controlling research analysts, including by influencing their compensation.
- *Research Budget Determination.* Investment banking personnel are prohibited from making determinations relating to the budget of the research department.

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FINRA member firms to resolve allegations of misconduct relating to offers of favorable research to win investment banking business. FINRA member firms subject to both settlements will be required to comply with the proposed Rule if it becomes effective.

<sup>3</sup> See proposed FINRA Rule 2241(b).

<sup>4</sup> FINRA noted that the proposed changes to the quiet periods do not affect any quiet periods that may be required under federal law. For instance, we expect that FINRA members would as a general matter refrain from publishing research reports during the 25-day prospectus delivery period imposed under the Securities Act of 1933 for IPOs in which they participate.

- *Compensation.* The proposed Rule requires that a committee that reports to the FINRA member firm's board of directors must review and approve at least annually the compensation of any research analyst who is primarily responsible for preparing the substance of a research report. The committee may not have any representation from the investment banking department. In addition, the compensation of research analysts may not be based upon specific investment banking services transactions or contributions to investment banking services activities.
- *Information Barriers.* Under the proposed Rule, FINRA members are required to establish information barriers or other safeguards to ensure that research analysts are insulated from review, pressure or oversight by persons engaged in investment banking services activities or certain other persons, such as sales and trading department personnel.
- *Retaliation.* The proposed Rule prohibits direct or indirect retaliation, or the threat of retaliation, against a research analyst by any person employed by the FINRA member or its affiliates based on the content of a research report or a public appearance by a research analyst. The prohibition extends to employees other than investment banking personnel, such as sales and trading and non-investment banking executives of FINRA members.
- *Solicitation and Marketing.* Research analysts are prohibited from participating in (1) pitches and other solicitations of investment banking services transactions by FINRA members and (2) road shows or other marketing on behalf of issuers related to such transactions.<sup>5</sup> Analysts are permitted, however, to listen to or view (in listen-only mode) live webcasts of a transaction-related road show and to attend, from a remote location or a separate room, widely attended presentations by investment banking personnel to investors or the sales force. This prohibition does not apply to an IPO of an EGC, provided the research analysts do not solicit investment banking services transactions or promise favorable research.
- *Joint Due Diligence and Other Interactions with Investment Banking Personnel.* Research analysts are prohibited from participating in due diligence sessions in the presence of investment banking personnel prior to the selection by an issuer of the underwriters for an offering.<sup>6</sup> Once the underwriting mandate has been awarded, joint due diligence may take place in accordance with appropriate policies and procedures that are designed to guard against interactions that may improperly further the interests of the investment banking department.<sup>7</sup>
- *Promises of Favorable Research and Pre-publication Review by Subject Company.* The proposed Rule maintains current prohibitions against promises of favorable research, a particular research

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<sup>5</sup> Proposed Rule 2241.01 codifies FINRA's existing interpretation that members may not include in pitch materials any information about a member's research capacity in a manner that might suggest, directly or indirectly, that the member might provide favorable research.

<sup>6</sup> See proposed Rule 2241.02.

<sup>7</sup> Proposed Rule 2241.03 clarifies that three-way meetings between research analysts and a current or prospective customer in the presence of investment banking department personnel about an investment banking services transaction are prohibited.

recommendation, rating or specific content of the research report as an inducement for receipt of business or compensation.<sup>8</sup> The proposal also prohibits the pre-publication review of a research report by a subject company for purposes other than the verification of facts. Sections of the draft research report may be provided to non-investment banking personnel or the subject company for factual review, provided that: (i) the draft does not contain the research summary, research rating or price target, (ii) a complete draft of the report is provided to legal or compliance personnel before sections are submitted to non-investment banking personnel or the subject company, and (iii) any subsequent proposed changes to the ratings or price target are accompanied by a written justification to legal or compliance personnel who provide written authorization for the change.<sup>9</sup>

- *Personal Trading Restrictions.* FINRA member firms are required to establish written policies and procedures that restrict or limit the trading by research analysts in securities covered by such analyst. Although the proposed Rule change does not impose record-keeping requirements, FINRA expects members to evidence compliance with their policies and procedures and retain any related documentation in accordance with FINRA Rule 4511, which generally requires that books and records be retained for six years. The proposed Rule further prohibits a research analyst from purchasing or selling any security in a manner inconsistent with the research analyst's recommendation.

## Content and Disclosure in Research Reports

The proposed Rule generally maintains the current disclosure requirements, with a few modifications. Specifically, the proposed Rule adds a requirement that FINRA members must establish, maintain and enforce written policies and procedures reasonably designed to ensure that the facts included in research reports are based on reliable information. The policies and procedures must be reasonably designed to ensure that any recommendation, rating or price target has a reasonable basis and is accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation, rating or price target.<sup>10</sup> In addition, the proposal expands upon the current "catch all" disclosure, which mandates disclosure of any material conflict of interest of the research analyst or member that the research analyst knows of, or has reason to know of, at the time of the publication or distribution of a research report or public appearance.<sup>11</sup> The proposed Rule goes beyond the existing provision by requiring disclosure of material conflicts known not only by the research analyst, but also by any "associated person of the member with the ability to influence the content of a research report."<sup>12 13</sup>

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<sup>8</sup> See proposed FINRA Rule 2241(b)(2)(K). For additional guidance, see Regulatory Notice 11-41 available at <http://www.finra.org/Industry/Regulation/Notices/2011/P124424>.

<sup>9</sup> See proposed Rule 2241.05.

<sup>10</sup> See proposed FINRA Rule 2241(c).

<sup>11</sup> FINRA considers it to be a material conflict of interest if the research analyst or a member of the research analyst's household serves as an officer, director or advisory board member of the subject company.

<sup>12</sup> See proposed FINRA Rule 2241(c)(4)(I).

The proposed Rule also modifies the disclosure requirement relating to beneficial ownership of the securities of the subject company to include debt holdings. The member must disclose if it or its affiliates maintain a significant financial interest in the debt or equity of the subject company, including, at a minimum, if the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. FINRA believes that “an equity research report that analyzes the creditworthiness of the subject company could impact the price of the company’s debt securities, and therefore a material conflict exists where the member or its affiliates maintain significant debt holdings in the subject company.”<sup>14</sup>

### Disclosures At Public Appearances

Under the proposed Rule the required disclosures at public appearances remain substantively the same as under the current Rule, with the following exception: similar to the modification with respect to disclosure in research reports, a research analyst is required to disclose at public appearances if a FINRA member or its affiliates maintains a significant financial interest in the debt or equity of the subject company. In addition, consistent with the current Rule, the proposed Rule requires a research analyst to disclose at public appearances whether a FINRA member provided investment banking services to the subject company in the previous 12 months, whether a FINRA member or its affiliates received any compensation for investment banking or other services from the subject company in the previous 12 months, whether the research analyst received any compensation from the subject company in the previous 12 months or has a financial interest in the debt or equity securities of the subject company and any other material conflict of interest of the research analyst or FINRA member. However, unlike in research reports, the “catch all” disclosure requirement at public appearances applies only to a conflict of interest of the research analyst or the FINRA member that the research analyst knows or has reason to know at the time of the public appearance and does not extend to conflicts that an associated person with the ability to influence the content of a research report or public appearance knows or has reason to know.

### Distribution of Research Reports

*Member Research Reports.* The proposed Rule requires FINRA members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that a research report is not distributed selectively to internal trading personnel or a particular customer or class of customers in advance of other customers that the member has previously determined are entitled to receive the research report.<sup>15</sup>

*Third-Party Research Reports.* The proposed Rule generally maintains the existing third-party research report distribution requirements, with one modification. Similar to the disclosure requirements discussed

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<sup>13</sup> Proposed FINRA Rule 2241.08 defines an associated person with the ability to influence the content of a research report as an associated person who, in the ordinary course of that person’s duties, has the authority to review the research report and change that research report prior to publication or distribution.

<sup>14</sup> The proposed Rule does not offer guidance on what constitutes “significant” debt holdings for the purposes of the Rule.

<sup>15</sup> See proposed FINRA Rule 2241(g).

above with respect to a member's own research reports, a distributing member would be required to disclose if the member or its affiliates maintains a significant financial interest in debt or equity securities of the subject company. The proposed Rule change also would require FINRA members to disclose any other material conflict of interest that can reasonably be expected to have influenced the member's choice of a third-party research provider or the subject company of a third-party research report.<sup>16</sup> In addition, the proposed Rule requires a member to establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party research report contains no untrue statement of a material fact and is otherwise not false or misleading. A member may satisfy this requirement based on its actual knowledge and reasonable diligence.<sup>17</sup>

### **Effective Date**

If approved, FINRA Rule 2241 will become effective no later than 180 days following publication of a notice announcing Commission approval.

To view and print the full text of the proposed rule change, please [click here](#).

### **Proposed Debt Research Rule**

FINRA has also proposed a new debt research rule, FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports).<sup>18</sup> Proposed Rule 2242 would apply a substantial portion of the equity research Rules discussed above to debt research distributed to retail investors. We will discuss proposed Rule 2242 in a future memorandum.

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<sup>16</sup> See proposed FINRA Rule 2241(h)(4).

<sup>17</sup> For additional guidance, see [Notice to Members 04-18](#) available at <http://www.finra.org/Industry/Regulation/Notices/2004/PO03223>.

<sup>18</sup> SEC Release No. 34-73623, File No. SR-FINRA-2014-048, available at <http://www.sec.gov/rules/sro/finra/2014/34-73623.pdf>

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