

Memorandum

FINRA Proposes New Debt Research Rule

January 13, 2015

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 new FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) to address conflicts of interest relating to the publication and distribution of debt research reports.¹ In a companion filing, FINRA also proposed a new equity research rule, FINRA Rule 2241 (Research Analysts and Research Reports),² that we discussed in a separate memorandum.³ Proposed Rule 2242 incorporates a substantial portion of the equity research rules as a basic framework for debt research distributed to retail investors, with certain modifications to reflect the different manner in which equity securities and debt securities are traded.

Conflicts of Interest

Similar to the proposed equity research rule, the proposed Rule 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 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, sales and trading and principal trading personnel, subject companies and customers.⁴ The required policies and procedures must address at a minimum the following areas:

- *Pre-publication Review.* The proposed Rule generally prohibits pre-publication review, clearance or approval of debt research by persons involved in investment banking, sales and trading or principal

¹ SEC Release No. 34-73623, File No. SR-FINRA-2014-048, available at <http://www.sec.gov/rules/sro/finra/2014/34-73623.pdf>.

² SEC Release No. 34-73622, File No. SR-FINRA-2014-047, available at <http://www.sec.gov/rules/sro/finra/2014/34-73622.pdf>.

³ *FINRA Proposes Rule Changes to Address Research Analyst Conflicts of Interest* available at <http://www.stblaw.com/about-us/publications/details?id=oc80d90e-743d-6a02-aaf8-ff0000765f2c>.

⁴ See proposed FINRA Rule 2242(b).

- trading. Sections of a draft debt research report may be provided to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or to the subject company for factual review, provided: (i) the sections of the draft debt research report submitted do not contain the research summary, recommendation or rating; (ii) a complete draft of the debt research report is provided to legal or compliance personnel before sections of the report are submitted to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company; and (iii) any subsequent proposed changes to the rating or recommendation are accompanied by a written justification to legal or compliance personnel who provide written authorization for the change.⁵
- *Coverage Decisions.* The proposed Rule requires that investment banking, sales and trading and principal trading personnel have only limited input in research coverage decisions. Personnel from these or other departments may convey customer interest to the research department, but final decisions regarding coverage must be made by the research department.
 - *Solicitation and Marketing.* Debt research analysts are prohibited from participating in (1) pitches and other solicitations of investment banking services transactions by FINRA members and (2) road shows and other marketing on behalf of issuers related to such transactions.⁶ Debt research analysts are permitted, however, to listen to or view (in listen-only mode) a live webcast of a transaction-related road show or to attend from a remote location or a separate room a widely-attended presentation by investment banking personnel to investors or the sales force.
 - *Supervision.* Persons engaged in investment banking activities, sales and trading or principal trading activities are prohibited from supervision or control of debt research analysts, including influence over their compensation. In addition, FINRA members must establish information barriers or other institutional safeguards to ensure that debt research analysts are insulated from review, pressure or oversight by persons engaged in investment banking services, principal trading or sales and trading activities or others who might be biased in their judgment or supervision.
 - *Budget and Compensation.* Investment banking and principal trading personnel are prohibited from making determinations relating to the budget of the debt research department. 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 debt research analyst who is primarily responsible for preparation of the substance of a research report. The committee may not have any representation from the investment banking or principal trading departments. In addition, the compensation of debt research analysts may not be based upon specific investment banking services or trading transactions or contributions to investment banking services or principal trading activities.

⁵ See proposed FINRA Rule 2242.05.

⁶ Proposed FINRA Rule 2242.01 codifies an existing FINRA interpretation that pitch materials may not include any information about a member's debt research capacity in a manner that might suggest, directly or indirectly, that the member might provide favorable debt research.

- *Personal Trading Restrictions.* FINRA member firms are required to establish written policies and procedures that restrict or limit trading by a debt research analyst account in securities, derivatives and funds whose performance is materially dependent upon the performance of securities covered by the debt research 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 debt research analyst account from purchasing or selling any security or any option or derivative of such security in a manner inconsistent with the debt research analyst's most recently published recommendation.
- *Retaliation.* The proposed Rule prohibits direct or indirect retaliation or threat of retaliation against debt research analysts by any employee of the FINRA member firm for publishing research or making a public appearance that may adversely affect the firm's current or prospective business.
- *Promises of Favorable Research.* The proposed Rule prohibits explicit or implicit promises of favorable debt research, specific research content or a specific rating or recommendation as inducement for the receipt of business or compensation.
- *Joint Due Diligence with Investment Banking Personnel.* Debt 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.⁷ 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 improperly further the interests of the investment banking department.
- *Communications Between Debt Research Analysts and Trading Personnel.* The proposed Rule prohibits sales and trading and principal trading personnel from attempting to influence a debt research analyst's opinions or views for the purpose of benefiting the trading positions of the FINRA member firm, a customer or a class of customers. The proposed Rule permits sales and trading and principal trading personnel to seek the views of debt research analysts regarding the creditworthiness of the issuer of a debt security and other information reasonably related to the price or performance of the debt security, as long as, with respect to any covered issuer, such information is consistent with the debt research analyst's published debt research report and is consistent in nature with the types of communications that a debt research analyst might have with customers.
- *Communications with Customers and Internal Sales Personnel.* The proposed Rule requires that any written or oral communications by a debt research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading. Debt research analysts may not engage in any communications with a current or prospective

⁷ See proposed FINRA Rule 2242.09.

customer in the presence of investment banking personnel about an investment banking services transaction.

Contents of and Disclosure in Debt Research Reports

The proposed Rule, in general, incorporates the same disclosures required in research reports under the proposed equity research rule, with certain modifications to accommodate the different characteristics of the debt market. The proposed Rule requires FINRA member firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that the facts included in their debt research reports are based on reliable information. The policies and procedures must be reasonably designed to ensure that any recommendation or rating 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 or rating.⁸ The proposed Rule incorporates a proposed amendment to the corresponding provision in the equity research rules that expands the existing “catch all” disclosure to require 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.⁹

If a debt research report includes a rating, the proposed Rule requires that the report disclose the percentage of all debt securities rated by such FINRA member that are assigned either a “buy,” “hold,” or “sell” rating, as well as the meaning of each such rating, including the time horizon and any benchmarks on which such rating is based.

The proposed Rule further requires a FINRA member to disclose in any debt research report at the time of publication or distribution of the report: (i) if the debt research analyst has a financial interest in the debt or equity securities of the subject company, received compensation based on the member’s investment banking, sales and trading or principal trading revenues or received any compensation from the subject company in the preceding 12 months; (ii) if the FINRA member or its affiliates managed or co-managed a public offering of securities for the subject company, or received compensation from the subject company for investment banking or other products or services in the preceding 12 months;¹⁰ (iii) if the FINRA member or its affiliates expect to receive or intend to seek compensation for investment banking services from the subject company in the next three months; (iv) if the FINRA member trades or may trade as principal in the debt securities subject to the debt research report; (v) if the subject company is or over the preceding 12 months has been a

⁸ See proposed FINRA Rule 2242(c).

⁹ Proposed FINRA Rule 2242.07 defines an associated person with the ability to influence the content of a debt research report as an associated person who, in the ordinary course of that person’s duties, has the authority to review the debt research report and change that debt research report prior to publication or distribution.

¹⁰ Proposed FINRA Rule 2242.04 provides that FINRA members may satisfy the disclosure requirement with respect to receipt of non-investment banking services compensation by an affiliate by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the affiliate as to whether the affiliate received such compensation.

client of the FINRA member and the types of services provided to the subject company; and (vi) any other material conflict of interest of the debt research analyst or FINRA member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has a reason to know at the time of the publication or distribution of a debt research report.¹¹

Disclosure in Public Appearances

The proposed Rule is consistent with the proposed equity research rule with respect to disclosure in public appearances. The proposed Rule requires a debt research analyst to disclose at public appearances: (i) if the debt research analyst has a financial interest in the debt or equity securities of the subject company or received any compensation from the subject company in the preceding 12 months; (ii) if the subject company is or has been a client of the FINRA member over the preceding 12 months and the types of services provided to the subject company; (iii) if the FINRA member or any affiliate thereof received any compensation from the subject company in the previous 12 months; and (iv) any other material conflict of interest of the debt research analyst or FINRA member that the debt research analyst knows or has a reason to know at the time of the public appearance. Unlike in debt research reports, the “catch all” disclosure requirement in public appearances applies only to a conflict of interest of the debt research analyst or FINRA member that the analyst knows or has a 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 public appearance knows or has reason to know.

Distribution of Debt 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 debt 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. FINRA members may provide different debt research products and services to different classes of customers, provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm discloses its research distribution practices to all customers that receive such a research product.¹²

Third-Party Research Reports. The proposed Rule incorporates the current standards for third-party equity research as well as the expanded requirement in the proposed equity research rules that FINRA members disclose any other material conflict of interest that can reasonably be expected to have influenced the

¹¹ Although the proposed equity research rule requires an additional disclosure if the FINRA member or its affiliates maintains a significant financial interest in the debt or equity of the subject company, including, at a minimum, beneficial ownership of 1% or more of any class of equity securities of the subject company, FINRA did not include this provision in the proposed debt research Rule because, unlike equity holdings, firms do not typically have systems to track ownership of debt securities. Therefore, the proposed debt research Rule requires disclosure of firm ownership of debt securities in research reports or a public appearance only to the extent those holdings constitute a material conflict of interest.

¹² See proposed FINRA Rule 2242.06.

member's choice of a third-party debt research provider or the subject company of a third-party debt research report. 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 debt 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.

Exemption for Debt Research Reports Provided to Certain Institutional Investors. The proposed Rule exempts debt research distributed solely to Qualified Institutional Buyers ("QIBs")¹³ and to "institutional accounts"¹⁴ from most of the provisions of the Rule other than the prohibitions on pre-publication review of debt research reports and participation in pitches and other solicitation of investment banking services transactions by debt research analysts. However, in order for a FINRA member to distribute such institutional research to an institutional account that is not a QIB, the institutional account must affirmatively consent in writing to receive such research that is not subject to the Rule. A FINRA member may distribute such institutional research to a QIB so long as the FINRA member has provided written disclosure to the QIB that the FINRA member may provide debt research that is not subject to all of the standards applicable to debt research prepared for retail investors, the QIB has not contacted the FINRA member to request that such research not be provided to the QIB, and the FINRA member complies with the suitability requirements of FINRA Rule 2111(b). The proposed Rule requires FINRA members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that institutional debt research is made available only to eligible institutional investors.

Effective Date

If approved, FINRA Rule 2242 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](#).

¹³ A "qualified institutional buyer" has the same meaning here as under Rule 144A of the Securities Act of 1933.

¹⁴ The term "institutional account" means 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 under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

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