



## FINRA Proposes Changes to the Equity Research Analyst and Equity Research Report Rule

On November 18, 2014, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed a proposed rule change with the Securities and Exchange Commission (the “SEC”) to adopt NASD Rule 2711 as new FINRA Rule 2241 with significant modifications.<sup>1</sup> The proposed changes reflect a more flexible principles-based approach and incorporate many of the FINRA interpretations that have developed since the 2005 changes to NASD Rule 2711.<sup>2</sup> The proposal also seeks to establish a level playing field as between investment banks subject to the “Global Settlement”<sup>3</sup> and those that are not, as well as for issuers that are emerging growth companies, or EGCs. Comments on the proposal are due December 16, 2014, 21 days after publication in the Federal Register, assuming no extension. If approved, Rule 2241 will be effective no later than 180 days following publication of the notice announcing the SEC’s approval of the rule.

Rule 2711<sup>4</sup> generally requires disclosure of conflicts of interest in equity research reports and public appearances by equity research analysts. The Rule prohibits certain conduct, such as investment banking personnel involvement in the content of equity research reports and in the determination of analyst compensation, where disclosure may not be sufficient to protect from the effects of conflicts of interest. The Rule requires separation between equity research and investment banking, proscribes conduct that could affect an equity research analyst’s objectivity and requires specific disclosures in equity research reports and public appearances. At the same time FINRA proposed new Rule 2241, FINRA issued a revised proposal for debt research reports and debt research analysts, which we discuss in a separate alert.

This Alert provides a brief overview of the more significant proposed changes to the equity research report rule. As used herein, “research analyst” and “research report” refers to equity research analysts and equity research reports.

### Definitions – Rule 2241(a)

Proposed Rule 2241(b)(2)(J) and existing NASD Rule 2711(g) require disclosure regarding conflicts of interest with “research analyst accounts.” The definition of “research analyst account” would clarify that the rule would not apply to a registered investment company over which a research analyst has discretion or control, provided

<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>. The proposed change from NASD to FINRA rule is part of FINRA’s creation of a consolidated rulebook. The proposal also amends NASD Rule 1050 (Registration of Research Analysts) and Incorporated NYSE Rule 344 to create an exception from the research analysts’ qualification requirement.

<sup>2</sup> Effective October 11 2012, Rule 2711 was amended to comply with the requirements of the Jumpstart Our Business Startups Act, or JOBS Act.

<sup>3</sup> In 2003, federal and state authorities and self-regulatory organizations reached a settlement with 10 of the nation’s largest broker-dealers to resolve allegations of misconduct involving conflicts of interest between their research analysts and investment bankers. In 2004, two additional firms settled substantively under the same terms, which included provisions to separate research from investment banking. Rule 2711 and the Global Settlement cover many of the same provisions but are not identical.

<sup>4</sup> Incorporated NYSE Rule 472 has substantially similar provisions. The proposal would eliminate NYSE Rule 472 as superfluous.

that the research analyst or a member of that research analyst's household has no financial interest in the investment company, other than a right to receive a performance or management fee. The definition of "research report" would specifically exclude communications concerning mutual funds, because sales material regarding mutual funds are covered by separate regulations, including FINRA Rule 2210 and Rule 482 under the Securities Act of 1933, as amended (the "Securities Act").

### **Identifying and Managing Conflicts of Interest – Rule 2241(b)**

The heart of Rule 2241 is section (b), "Identifying and Managing Conflicts of Interest." The section fundamentally reorganizes NASD Rule 2711 and sets forth the principles underlying the revised rule. Section (b)(1) requires member firms to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to (a) the preparation, content and distribution of research reports, (b) public appearances by research analysts, and (c) the interaction between research analysts and persons outside of the research department, including investment banking and sales and trading personnel, the subject companies and customers.

In the Supplemental Material that is part of the rule itself, FINRA includes some prescriptive requirements. In Supplemental Material .02, "Joint Due Diligence," FINRA states that it interprets clause (c) referenced above to prohibit joint due diligence sessions involving a research analyst in the presence of investment banking department personnel *prior* to the selection by the issuer of the underwriters for the investment banking transaction. In its explanation, FINRA states it believes there is heightened risk under these circumstances that investment bankers may pressure analysts to promise or produce favorable research in order to improve the firm's chances of being retained by the issuer. Once a mandate has been awarded, FINRA believes joint due diligence sessions may take place in accordance with appropriate policies and procedures. Following the award of a mandate, FINRA believes that the efficiencies of joint due diligence sessions outweigh the risk of pressure on research analysts by investment banking. Also, FINRA understands that typically an analyst that is participating in due diligence activities will not be publishing research at that time either due to the existence of quiet periods under the Securities Act offering rules or because the analyst has been brought "over the wall."

Supplemental Material .03(b) reiterates FINRA's existing interpretation that any written or oral communication by a research analyst with a current or prospective customer or with internal personnel related to an investment banking transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

Section (b)(2) outlines the principal matters to be addressed by member firms in their policies and procedures. Most of the below minimum requirements were already included in Rule 2711 but the restatement provides some flexibility for implementation based on a member's size and structure. At the same time the rule is intended to require member firms to be more proactive in identifying and managing conflicts as new research products, affiliations and distribution methods emerge. We offer (in italics) additional material and commentary on certain of the proposed changes under the relevant requirement.

- A. prohibit prepublication review, clearance or approval of research reports by persons engaged in investment banking services activities and restrict or prohibit such review, clearance or approval by other persons not directly responsible for the preparation, content and distribution of research reports, other than legal and compliance personnel;

*This provision maintains the current prohibition on prepublication review of research reports by investment banking personnel, but eliminates the exception in paragraph (b)(3) of Rule 2711 that permits pre-publication review of research reports by investment banking to verify the factual accuracy of information in a research report. FINRA stated that it believes that review of facts in a report by investment banking is unnecessary in light of the numerous other sources available to verify factual information, including the subject company, and only raises concerns about the objectivity of the report and invites pressure on a research analyst. This change*

also establishes parity among firms party to or not party to the Global Settlement, because factual review by investment banking personnel is not permitted under the terms of the Global Settlement. The proposal requires policies and procedures reasonably designed to at least restrict prepublication review by other non-research personnel, other than legal and compliance personnel. Thus, a firm must specify in its policies and procedures the circumstances, if any, under which such review would be permitted as necessary and appropriate; for example, where non-research personnel are best situated to verify selected facts or where administrative personnel review a report for formatting.

- B. restrict or limit input by investment banking department into research coverage decisions to ensure that research management independently makes all final decisions regarding the research coverage plan;

*This provision makes express FINRA's interpretation that the separation requirements in current Rule 2711(b)(1) prohibit investment banking personnel from making final coverage decisions. The proposed provision does not preclude investment banking personnel from conveying customer interests or providing input into coverage considerations, so long as final decisions regarding the coverage plan are made by research management.*

- C. prohibit persons engaged in investment banking activities from supervising or controlling research analysts, including exerting influence or control over research analyst compensation evaluation and determination;
- D. limit determination of research department budget to senior management, excluding senior management engaged in investment banking services activities;
- E. prohibit research personnel compensation based upon specific investment banking transactions or contributions to a member firm's investment banking activities;
- F. require that the compensation of a research analyst who is primarily responsible for preparation of the substance of a research report be reviewed and approved at least annually by a committee that reports to a member firm's board of directors, or if the member firm has no board of directors, a senior executive officer of the member firm. This committee may not include representation from the member's investment banking department. The committee must consider the following factors when reviewing a research analyst's compensation, if applicable, and document its determinations:
  - i. the research analyst's individual performance, including the analyst's productivity and the quality of the analyst's research;
  - ii. the correlation between the research analyst's recommendations and the performance of the recommended securities; and
  - iii. the overall ratings received from clients, sales force and peers independent of the member's investment banking department, and other independent ratings services.
- G. establish information barriers or other institutional safeguards to ensure that research analysts are insulated from review, pressure or oversight by persons engaged in investment banking activities or other persons, including sales and trading department personnel, who might be biased in their judgment or supervision;

*In its discussion of this provision, FINRA emphasized that the separation between investment banking and research is of particular importance. While the proposed rule does not mandate physical separation, "FINRA would expect" such physical separation except in "extraordinary circumstances where the costs are*

*unreasonable due to a firm's size and resource limitations." FINRA also expanded the concept of separation to include "other persons, including sales and trading department personnel, who might be biased in their judgment or supervision."*

- H. prohibit direct or indirect retaliation or the threat of retaliation against research analysts employed by the member firm or its affiliates by persons engaged in investment banking services activities or other employees as the result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the member firm's present or prospective business interests;
- I. define periods during which the member firm must not publish or otherwise distribute research reports, and during which period research analysts must not make public appearances, relating to the issuer, of:
  - i. a minimum of 10 days following the date of an initial public offering if the member firm has participated as an underwriter or dealer in the initial public offering; or
  - ii. a minimum of three days following the date of a secondary offering if the member firm has acted as a manager or co-manager of that offering.

Subparagraph (I) shall not apply to the publication or distribution of a research report or a public appearance following an initial public offering or secondary offering of the securities of an EGC;

*The above change is likely to have a significant impact on the offering process. The proposal not only substantially shortens the quiet period, it also eliminates the differing treatment of managing underwriters and the other underwriters in the offering. Even more important, the proposed rule change also eliminates the current quiet periods 15 days before and after the expiration, waiver or termination of a lock-up agreement. FINRA stated that it believes that research issued during such periods potentially offers valuable market information, and the other provisions of the research rules and SEC Regulation AC provide sufficient protections. This change will also provide parity between EGCs and other kinds of issuers.*

- J. restrict or limit research analyst account trading in securities, derivatives of such securities and funds whose performance materially depends upon the performance of securities covered by the research analyst, including:
  - i. ensuring that research analyst accounts, supervisors of research analysts and associated persons with the ability to influence the content of research reports do not benefit in their trading from knowledge of the content or timing of a research report before the intended recipients of such research have had a reasonable opportunity to act on the information in the research report;
  - ii. providing that no research analyst account may purchase or sell any security or any option on or derivative of such security in a manner inconsistent with the research analyst's recommendation as reflected in the most recent research report published by the member firm, and defining financial hardship circumstances, if any (e.g., an unanticipated significant change in the personal financial circumstances of the beneficial owner of the research analyst account), in which the member will permit a research analyst account to trade in a manner inconsistent with such research analyst's most recently published recommendation; and
  - iii. prohibiting a research analyst account from purchasing or receiving any security before an issuer's initial public offering if the issuer is principally engaged in the same types of business as companies that the research analyst follows;

*Existing Rule 2711 contains detailed rules on research analyst trading, including blackout periods and pre-approval requirements. Clause J is intended to implement a “more encompassing and flexible supervisory approach” while maintaining certain existing prohibitions, such as the analyst not being able to receive pre-IPO shares. Supplemental material accompanying the proposal clarifies the circumstances under which an analyst will not be seen as trading in manner inconsistent with the analyst’s recommendation.*

- K. prohibit explicit or implicit promises of favorable research, a particular research rating or recommendation or specific research content as inducement for the receipt of business or compensation;
- L. restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, including prohibiting:
  - a. participation in pitches and other solicitations of investment banking services transactions; and
  - b. participation in road shows and other marketing on behalf of an issuer related to an investment banking services transaction;

*The proposal also adds Supplemental Material .01, which codifies the existing interpretation that the pitch provision prohibits member firms from including in pitch materials any information about a member’s research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable research coverage. The pitch material may include the fact of coverage and the name of the research analyst.*

*The prohibition on participation in pitch meetings does not apply to a research analyst that attends a pitch meeting in connection with an IPO of an EGC if the meeting is also attended by investment banking personnel, as permitted by the JOBS Act.*

- M. prohibit investment banking department personnel from directly or indirectly:
  - a. directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction; and
  - b. directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction;

*Supplemental Material .03(a) clarifies that no research analyst may engage in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking transaction.*

- N. prohibit prepublication review of a research report by a subject company for purposes other than verification of facts.

*Supplemental Material .05 maintains FINRA’s current guidance that sections of a draft research report may be provided to non-investment banking personnel or to the subject company for factual review so long as: (a) the sections of the report submitted do not contain the research summary, the research rating or the price target; (b) a complete draft of the report is provided to legal or compliance personnel before sections of the report are submitted to non-investment banking personnel or the subject company; and (c) if, after submitting sections of the report to non-investment banking personnel or the subject company, the research department intends to change the proposed rating or price target, it must first provide written justification for the change to, and receive written authorization from, legal or compliance personnel.*

## Content and Disclosure in Research Reports

Proposed Rule 2241(c) sets forth the general principle that a member firm should adopt written policies and procedures relating to the content of, location of disclosures within, and procedures for, research reports. There are few changes from existing requirements although some are recast as policies and procedures rather than requirements. For example, Proposed Rule 2241(c)(1)(A) requires the adoption of policies and procedures reasonably designed to ensure that purported facts in the report are based on reliable information. In addition to proposed specific disclosure requirements regarding conflicts of interest that are substantively the same as existing requirements, the proposed rule expands the “catch all” disclosure 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.” FINRA’s intention is to capture material conflicts that may be known only to a supervisor or the head of research. In FINRA’s view, the “reason to know” standard would not impose a duty of inquiry on the research analysts or others but rather “it would cover disclosure of those conflicts that should reasonably be discovered by those persons in the ordinary course of discharging their functions.”<sup>5</sup>

Proposed Rule 2241(c)(4)(F) expands the disclosure requirements relating to beneficial ownership of 1% or more of the securities of a subject company in order to include, in addition to common equity interests, to include debt and other forms of equity. FINRA stated 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 maintains significant debt holdings in the subject company.”

## Public Appearances

Proposed Rule 2241(d) is generally unchanged substantively from Rule 2711 with the addition of the requirement to disclose ownership of debt securities similar to Rule 2241(c)(4)(F). However the “catch all” disclosure requirement remains applicable only to the research analyst and would not be applicable to any other person, unlike current Rule 2241(c).

## Other Provisions

Proposed Rule 2241(e), covering compliance with other rules, Rule 2241(f), termination of coverage, Rule 2241(g), distribution of member research reports, Rule 2241(g), distribution of third-party research reports, are generally substantively the same as their Rule 2711 predecessors with certain modifications, codifications of existing interpretations and changes necessary for consistency with other provisions of the proposed rule.

Proposed Rule 2241(i) maintains and expands the exemptions in existing Rule 2711(k) available to member firms with limited investment banking activity, which is defined as firms that have managed or co-managed 10 or fewer investment banking transactions and generated \$5 million or less in gross revenues from such transactions. The proposed rule also eliminates the existing requirement for annual attestation that the member firm has the necessary policies and procedures in effect. FINRA stated that other existing rules already cover this obligation, which made its continuation unnecessary.

**For more information about the separation of research and investment banking, see our Frequently Asked Questions, available at [www.tinyurl.com/qhd3vby](http://www.tinyurl.com/qhd3vby).**

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<sup>5</sup> Proposed Rule 2241(c)(4)(I).



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