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# FINRA Proposes Limited Safe Harbor for Desk Commentaries From Certain Requirements of FINRA Equity and Debt Research Rules

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FINRA recently published a proposal<sup>[1]</sup> to establish a limited safe harbor (the “Safe Harbor”) for desk commentaries<sup>[2]</sup> from certain requirements of FINRA’s equity and debt research rules (the “FINRA Research Rules”).

The comment period for the same expires on May 30, 2017.

Part I of this note provides an overview of the Safe Harbor’s expected impact, if adopted; Part II provides background regarding relevant issues;<sup>[3]</sup> Part III describes the types of communications eligible for the Safe Harbor; Part IV sets forth the policy-and-procedure and

disclosure requirements of the Safe Harbor; and Part V provides analysis of the proposal.

## Overview of Expected Impact

### **Debt Desk Commentaries**

For desk commentaries regarding debt securities, the Safe Harbor would not materially expand relief from the requirements of FINRA's debt research rule (the "Debt Research Rule") beyond that already provided under the rule's exemptions for institutional-only debt research (the "Institutional-Only Debt Research Exemption"). The chief benefit of the Safe Harbor for firms distributing debt desk commentaries, then, would seem to be that FINRA has proposed a structure that explicitly acknowledges the permissibility of externally-distributed written commentaries by personnel sitting on sales and trading desks.

### **Equity Desk Commentaries**

Because FINRA's equity research rule (the "Equity Research Rule") does not have an institutional-only exemption, and because FINRA licensing is required for equity research analysts and research principals, the Safe Harbor would be the source of somewhat broader relief for equity desk commentaries. The Safe Harbor would still require many of the policy-and-procedure requirements of the Equity Research Rule, but company-specific disclosures will not be required, and personnel producing equity desk commentaries and those reviewing such commentaries would be exempted from FINRA

research licensing requirements, among other exemptions.

## Background

Desk commentaries are brief written analyses generated by sales and trading desk personnel and distributed to institutional investors, generally with respect to near-term or very recent market events. Fundamental research, on the other hand, is more in-depth and is produced by personnel in a research department.

Since the enactment of the Equity Research Rule and, especially, the 2016 establishment of FINRA's Debt Research Rule, firms had struggled with the question of which policies and procedures to establish for desk commentaries and the personnel who produce them, given that some desk commentaries could arguably be "research reports" under the FINRA Research Rules. The definition of a research report under the Equity Research Rule is "any written...communication that includes an analysis of equity securities of individual companies or industries...and that provides information reasonably sufficient upon which to base an investment decision," subject to exceptions for certain types of analysis including macroeconomic analysis. The definition of debt research report is similar. The conundrum is that some desk commentaries, although brief, arguably provide analysis that is "reasonably sufficient upon which to base an investment decision," and thus would trigger the applicability of the FINRA Research Rules.

Given that both the Equity and Debt Research Rules require firms producing such reports to establish structural protections against conflicts of interest that may be impractical to apply to desk

personnel, firms had to closely consider the impact of the FINRA Research Rules on desk commentaries.

In explaining the rationale for the Safe Harbor proposal, FINRA makes the important and welcome note that institutional investors value timely flow of information and trade ideas from desk personnel, and understand the types of potential conflicts that may exist in the generation of trade ideas.

## Communications Eligible for Safe Harbor

The Safe Harbor is limited to communications that meet the following conditions.

- Author. The communication must be produced by sales and trading and principal trading personnel who:
  - Are not primarily engaged in the preparation of research reports that do not meet the safe harbor content limitation (described below);
  - Do not require registration as a research analyst pursuant to NASD Rule 1050 because their primary job function is something other than to provide investment research; and,
  - Do not report directly or indirectly to research department personnel.
  
- Content. The communication must be limited to brief observations (not including a rating, price target, or earnings estimate) regarding recent, current, or near term expected

trading activity, trading ideas or opportunities, market conditions, economic statistics or company results, or regarding a recent recommendation or research report.

- While the Safe Harbor prohibits desk commentary from including the author’s own rating, price target, or earnings estimate, it would not preclude referencing a rating, price target, or earnings estimate in other published research, including from the firm’s own research department, or discussing the directional effect of an event on an issuer’s rating, price target, or earnings.
  
- Recipient. The communication may only be distributed to:
  - Consenting investors that meet the definition of “institutional account” under FINRA Rule 4512(c) and have satisfied the FINRA Rule 2111 institutional suitability standard with respect to equity or debt transactions or trading strategies, as applicable.

As noted in the “Recipient” bullet, the Safe Harbor is limited to desk commentaries distributed to consenting institutional investors. The Safe Harbor permits negative consent processes to be used to obtain consent from all investors meeting the definition of institutional account under Rule 4512(c) (which definition includes all entities with \$50 million or more of total assets), whereas the Institutional-Only Debt Research Exemption requires affirmative consent from investors that meet the Rule 4512 test but not the definition of a Qualified Institutional Buyer. The proposal includes a 90-day transition period in which the Safe Harbor would be available even if the firm has not received the necessary consent.

# Policy-and-Procedure and Disclosure Requirements of the Safe Harbor

## Policy-and-Procedure Requirements

The following chart sets forth the policy-and-procedure obligations that must be fulfilled to comply with the Safe Harbor, and contrasts them with the obligations required by the Equity Research Rule and the Debt Research Rule (as applied to firms producing only institutional debt research).<sup>[4]</sup> As the Safe Harbor refers to desk commentaries as research reports and personnel who produce such commentaries as research analysts, this chart does the same.

DESCRIPTION OF PROVISION	EQUITY RESEARCH RULE	EQUITY DESK COMMENTARY SAFE HARBOR	DEBT	
			RESEARCH RULE FOR ONLY INSTITUTIONAL RESEARCH	DEBT DESK COMMENTARY SAFE HARBOR
<u>Market manipulation:</u> Prevent the use of research reports or research analysts to manipulate the market.	Not expressly, but would be required based on other law and regulation and catch-all conflicts	Yes	Not expressly, but would be required based on other law and regulation and catch-all conflicts provision of rule	Yes

DESCRIPTION OF PROVISION	EQUITY RESEARCH RULE	EQUITY DESK COMMENTARY SAFE HARBOR	DEBT RESEARCH RULE FOR ONLY INSTITUTIONAL RESEARCH	DEBT DESK COMMENTARY SAFE HARBOR
	provision of rule			
<u>Prohibition on pre-publication review of reports by investment banking personnel</u>	Yes	Yes	Yes	Yes
<u>Policies to insulate analysts from pressure, review, oversight of certain personnel:</u> Establish information barriers or other institutional safeguards to ensure that research analysts are insulated from review, pressure or oversight from persons involved in investment banking, sales and	Yes	Only with respect to insulation from pressure (not oversight or review). NB: other Safe Harbor provisions described below prohibit supervision or control by investment banking personnel FINRA: "In the context of desk	Only with respect to insulation from pressure (not oversight or review)	Only with respect to insulation from pressure (not oversight or review) FINRA: "In the context of desk commentary, FINRA does not interpret 'pressure' ... to exist merely because a firm produces desk commentary on securities in which it trades

DESCRIPTION OF PROVISION	EQUITY RESEARCH RULE	EQUITY DESK COMMENTARY SAFE HARBOR	DEBT RESEARCH RULE FOR ONLY INSTITUTIONAL RESEARCH	DEBT DESK COMMENTARY SAFE HARBOR
trading, principal trading (for debt research), and others who might be biased in their judgment and supervision.		commentary, FINRA does not interpret 'pressure'... to exist merely because a firm produces desk commentary on securities in which it trades or the authors of desk commentary report to such personnel .... Although FINRA does not interpret this requirement to require altering a firm's internal reporting lines, a firm must put in place policies and procedures reasonably designed to		or the authors of desk commentary report to such personnel .... Although FINRA does not interpret this requirement to require altering a firm's internal reporting lines, a firm must put in place policies and procedures reasonably designed to ensure that investment banking personnel or sales and trading and principal trading personnel do not overtly pressure a

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		<p>ensure that investment banking personnel or sales and trading and principal trading personnel do not overtly pressure a person who produces desk commentary to express a particular view.”<sup>[5]</sup></p>		<p>person who produces desk commentary to express a particular view.”<sup>[6]</sup></p>
<p><u>Prohibit retaliation:</u> Prohibit direct or indirect retaliation or threats of same against research analysts by any employee as the result of an adverse, negative,</p>	<p>Yes</p>	<p>Yes</p>	<p>Yes</p>	<p>Yes</p>

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or otherwise unfavorable research report that may negatively affect the firm's present or prospective business interests.				
<u>Promises of favorable research</u> : 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.	Yes	Yes	Yes	Yes
<u>Objectivity of analysts, including</u>	Yes	Yes	Yes	Yes

DESCRIPTION OF PROVISION	EQUITY RESEARCH RULE	EQUITY DESK COMMENTARY SAFE HARBOR	DEBT RESEARCH ONLY INSTITUTIONAL RESEARCH	DEBT DESK COMMENTARY SAFE HARBOR
<p><u>prohibition on participating in investment banking pitches and solicitations:</u></p> <p>Restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, including prohibiting:</p> <p>(i) participation in pitches and other solicitations of investment banking services transactions; and</p> <p>(ii) participation in road shows and other marketing on behalf of an issuer related to</p>		<p>FINRA notes:</p> <p>“This condition would not prohibit a person in the sales and trading or principal trading department from engaging in ordinary course communications related to the distribution of securities in an offering, including, for example, forwarding written materials from the syndication desk to customers, provided that the person was not <u>concurrently</u> publishing desk</p>		<p>FINRA notes:</p> <p>“This condition would not prohibit a person in the sales and trading or principal trading department from engaging in ordinary course communications related to the distribution of securities in an offering, including, for example, forwarding written materials from the syndication desk to customers, provided that the person was not <u>concurrently</u> publishing desk</p>

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an investment banking services transaction.		commentary related to the issuer or the investment banking services transaction.”		commentary related to the issuer or the investment banking services transaction.”
<u>Prohibit investment banking direction re marketing and communications:</u> Prohibit investment banking department personnel from directly or indirectly: (i) directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction; and	Yes	Yes	Yes	Yes

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(ii) directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction.				
<u>Review by subject company:</u> Prohibit prepublication review of research reports by a subject company.	Yes, but subject company review for fact checking is permitted	Yes. Subject company review for fact checking is <u>prohibited</u> FINRA notes: "FINRA believes it would be inconsistent with the scope and temporal nature of desk commentary to permit such review."	Yes, but subject company review for fact checking is permitted	Yes. Subject company review for fact checking is <u>prohibited</u> FINRA notes: "FINRA believes it would be inconsistent with the scope and temporal nature of desk commentary to permit such review."
<u>Restrictions on</u>	Yes	Yes	Yes	Yes

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<u>analyst communications with customers:</u> Prohibition on research analyst communication with current or prospective customer in the presence of investment banking personnel or company management about an investment banking services transaction.				
<u>Supervision or control by investment banking:</u> Prohibit persons engaged in investment banking activities	Yes	Yes	No	No

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<p>from supervision or control of research analysts, including influence or control over research analyst compensation evaluation and determination</p>				
<p><u>Budget determinations:</u> Limit determination of research dept. budget to senior management, excluding senior management engaged in investment banking (or, for debt, principal trading activities), and without regard to specific</p>	Yes	Yes	No	No

DESCRIPTION OF PROVISION	EQUITY RESEARCH RULE	EQUITY DESK COMMENTARY SAFE HARBOR	DEBT RESEARCH RULE FOR ONLY INSTITUTIONAL RESEARCH	DEBT DESK COMMENTARY SAFE HARBOR
revenues or results derived from investment banking.				
<u>Basis of analyst compensation:</u> Prohibit compensation of research analysts based on specific investment banking services or contribution to a firm's investment banking services or principal trading activities.	Yes	Yes. FINRA notes: "This requirement would not prohibit a firm from compensating a person in the sales and trading or principal trading department in the form of sales credits in connection with the distribution of securities in an offering, provided that the person had not published	No	No

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		<p>desk commentary related to those investment banking services transactions.”</p>		

## Disclosure Requirements

The Safe Harbor would require desk commentary to include a “health warning” similar to what is required for debt research distributed pursuant to the Institutional-Only Debt Research Exemption. The health warning would be required to state:

- “This document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to research reports prepared for retail investors”; and,
- If applicable, “Clients should assume that this document is not independent of [Firm’s] proprietary interests. [Firm] trades, and will continue to trade, the securities covered in this document for its own account and on a discretionary basis on behalf of

certain clients. Such trading interests may be contrary to or entered into in advance of this document.”

## Analysis

### **Debt Desk Commentaries**

Generally, the Safe Harbor provides exemption from only the very same policy-and-procedure requirements that are excluded by the existing Institutional-Only Debt Research Exemption. The only respect in which the Safe Harbor expressly offers broader relief is that it permits consent to be received through a negative consent process for accounts that meet the “institutional account” standard of Rule 4512 (which definition includes all entities with \$50 million or more of total assets) but not the definition of a Qualified Institutional Buyer. The Debt Research Rule requires affirmative consent from such investors for the Institutional-Only Debt Research Exemption to apply.

It would seem then that the chief benefit of the Safe Harbor for firms producing debt desk commentaries is that FINRA has proposed a structure that explicitly acknowledges the permissibility of externally-distributed written commentaries by personnel sitting on sales and trading desks, provided that the Safe Harbor’s conditions are complied with. Although there had been guidance from FINRA with respect to the Debt Research Rule that suggested that the rule did not prohibit desk commentaries if proper policies and procedures were established, the establishment of the Safe Harbor would presumably remove doubt as to FINRA’s view.

## Equity Desk Commentaries

Because the Equity Research Rule does not have an institutional-only research exemption and because FINRA rules require specific licensing for equity research analysts and research principals, the Safe Harbor for equity desk commentaries provides more significant substantive exemptions than those described for debt desk commentary.

First, the Safe Harbor provides an exemption from compliance with the licensing requirements for equity research analysts. Persons producing equity desk commentaries as well as research principals would therefore be excluded from the licensing requirements in respect of those activities.

The Safe Harbor also exempts equity desk commentary from certain of the substantive requirements of the Equity Research Rule, including committee review of analyst compensation and restrictions on analyst trading, as well as the particularized disclosures regarding conflicts of interest.

## Footnotes

[1] The proposal set forth in Regulatory Notice 17-16 is available at [https://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Regulatory-Notice-17-16.pdf](https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-16.pdf)

[2] Desk commentaries are brief written analyses generated by sales and trading desk personnel and distributed to institutional investors, generally with respect to near-term and very recent market events. Fundamental research, on the other hand, is more in-depth and is produced by personnel in a research department.

[3] For additional background, please see FINRA's New Fixed-Income Research Rule and Modifications to Equity Research Rule (Oct. 2015), currently available at: <http://www.shearman.com/en/newsinsights/publications/2015/10/finra-rule-2242-and-rule-2241>; FINRA Proposes Revisions to Fixed-Income Research Rule (May 2016),

currently available at: <http://www.shearman.com/en/newsinsights/publications/2016/05/finra-revisions-to-fixed-income-research-rule>; and SEC Approves Changes to NASD and NYSE Rules Relating to Research Analyst Conflicts of Interest (Aug. 2003), , currently available at: [http://www.shearman.com/~media/files/newsinsights/publications/2003/08/sec-approves-changes-to-nasd-and-nyse-rules-rela\\_\\_\\_/files/download-pdf-sec-approves-changes-to-nasd-and-ny\\_\\_\\_/fileattachment/sd\\_o8\\_o3.pdf](http://www.shearman.com/~media/files/newsinsights/publications/2003/08/sec-approves-changes-to-nasd-and-nyse-rules-rela___/files/download-pdf-sec-approves-changes-to-nasd-and-ny___/fileattachment/sd_o8_o3.pdf)

[4] Please note that the columns regarding the Equity Research Rule and Debt Research Rule for Institutional-Only Research assume that the exemptions for firms with limited investment banking or principal trading activity are not available.

[5] FINRA also notes: “As with the institutional debt exemption, compliance with this safe harbor condition would not require physical separation between persons who produce eligible desk commentary and sales and trading and principal trading department personnel, but absent such physical barriers, firms must implement and document other policies and procedures to achieve compliance with this condition.”

[6] *Id.*

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