

To Our Clients and Friends

Memorandum



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New FINRA Research Rules

Recently, the Financial Industry Regulatory Authority, Inc. (“FINRA”) announced the effective dates for amendments to its existing equity research rules (codified in new FINRA Rule 2241, the “Amended Equity Rule”) and its new debt research rule (codified in new FINRA Rule 2242, the “New Debt Rule” and, together with the Amended Equity Rule, the “New Research Rules”),¹ which were previously approved by the Securities and Exchange Commission on July 16, 2015.² Certain provisions of the Amended Equity Rule will become effective on September 25, 2015 (including those that change the quiet periods relating to public offerings) with the remainder becoming effective on December 24, 2015, while the New Debt Rule will become effective on February 22, 2016.

Member firms that produce debt research will for the first time need to establish policies and procedures in order to comply with the New Debt Rules, while member firms that produce equity research will need to assess and modify their existing policies and procedures in light of the changes made to the existing equity research rules.

In addition to implementing rules governing debt research for the first time, the New Research Rules, among other notable changes, substantially reduce the research quiet periods following IPOs and secondary offerings, eliminate the quiet periods before and after the expiration, waiver or termination of lock-up agreements entered into in connection with public offerings, and exempt debt research reports issued solely to certain institutional investors from many of the requirements of the New Debt Rule.

A summary of the key provisions of the New Research Rules is set out below.

Identifying and Managing Conflicts of Interest

The New Research Rules require FINRA members to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage (1) conflicts of interest related to the preparation, content and distribution of research reports, (2) public appearances by research analysts and (3) the interaction between research analysts and persons outside the research department, including investment banking, sales/trading and principal trading personnel, subject companies and customers. The following is a summary of the notable requirements that must be established by these written policies and procedures:

¹ See FINRA Regulatory Notice 15-30 (August 2015) relating to the Amended Equity Rule available [here](#) and FINRA Regulatory Notice 15-31 (August 2015) relating to the New Debt Rule available [here](#).

² See SEC Release No. 34-75471 (July 16, 2015) relating to the Amended Equity Rule available [here](#) and SEC Release No. 34-75472 (July 16, 2015) relating to the New Debt Rule available [here](#).

- **Research quiet periods:** The quiet periods during which member firms must not publish or distribute research reports and its research analysts must not make public appearances relating to the subject issuer have been substantially reduced. The Amended Equity Rule replaces the 40-day quiet period imposed on a member firm acting as manager or co-manager of an IPO and the 25-day quiet period imposed on a member firm participating as an underwriter or dealer in an IPO with a minimum period of 10 days following the date of an IPO³ if the member firm has participated as an underwriter or dealer in the IPO. The Amended Equity Rule also replaces the 10-day quiet period imposed on a member firm acting as manager or co-manager of a secondary offering with a minimum period 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.⁴ The Amended Equity Rule retains the exceptions permitting issuing research reports or analysts making public appearances within these quiet periods concerning the effects of significant news or events on the subject issuer or, in the case of secondary offerings, pursuant to Rule 139 under the Securities Act of 1933, as amended (the “Securities Act”) for companies with actively traded securities. In addition, the Amended Equity Rule eliminates the requirement for a 15-day quiet period before and after the expiration, waiver or termination of a lock-up agreement entered into in connection with a public offering. The New Debt Rule does not impose offering-related quiet periods.
- **Pre-publication review of research:** The Amended Equity Rule no longer allows for the pre-publication review of research reports by investment banking personnel to verify factual accuracy. The New Debt Rule expands the scope of those prohibited from reviewing debt research reports to include principal trading and sales/trading personnel in addition to investment banking personnel, but is otherwise substantially similar to the Amended Equity Rule. The subject company and non-investment banking personnel (and, in the case of debt research reports, non-principal trading and non-sales/trading personnel) are still allowed to review sections of a draft research report for factual accuracy provided certain conditions are met, including: (1) the report may not contain the research summary, research rating or price target (in the case of equity research reports) or recommendation (in the case of debt research reports); (2) a complete draft of the report is provided to legal or compliance personnel first; and (3) any subsequent proposed changes to the rating or price target (in the case of equity research reports) or recommendation (in the case of debt research reports) are accompanied by a written justification to legal or compliance and receive written authorization for the change. The member firm also must retain copies of any draft and the final version of the report for three years.
- **Solicitation and marketing of investment banking transactions:** Consistent with the existing equity research rules, the New Research Rules prohibit the solicitation and marketing of investment banking transactions. At a minimum, the written policies and procedures must prohibit research analysts from participating in (1) pitches and other solicitations of investment banking services transactions and (2) road shows and other marketing on behalf of issuers related to such investment banking transactions. However, research analysts may listen to or view a live webcast of a transaction related road show or other widely attended presentation by investment banking

³ The date of the offering for an IPO or secondary offering is the later of the effective date of the registration statement or the first date on which the securities were bona fide offered to the public. See FINRA Regulatory Notice 15-30 (August 2015) at p. 5.

⁴ These quiet periods do not apply following the IPO or secondary offering of an emerging growth company (“EGC”).

personnel to investors or the sales force if analysts do so from either a remote location or another room if they are in the same location. The New Research Rules also codify the existing interpretation prohibiting member firms from including in pitch materials any information about their research capacity that could suggest that the member firm could provide favorable research.

- **Research coverage plan:** The Amended Equity Rule requires member firms to prohibit input by investment banking personnel into equity research coverage decisions. The New Debt Rule is more restrictive by requiring firms to limit or restrict input by sales/trading and principal trading personnel as well as by investment banking personnel. Investment banking personnel and personnel from any other department are not precluded from conveying customer interests or providing input into coverage considerations provided the final decision regarding the coverage plan is made by research management.
- **Supervision and control of research analysts:** The New Research Rules maintain the prohibition in the existing equity research rules prohibiting investment banking personnel (and, in the case of the New Debt Rule, sales/trading and principal trading personnel) from any supervision or control of research analysts.
- **Restrictions on budget decisions:** The New Research Rules require member firms to limit the determination of the research department budget to senior management, excluding investment banking personnel (and, in the case of the New Debt Rule, principal trading personnel).
- **Research analyst compensation decisions:** The New Research Rules prohibit compensation based upon specific investment banking services (and, in the case of debt research analysts, trading transactions) or contributions to a member firm's investment banking activities (and, in the case of debt research analysts, principal trading activities). Additionally, the compensation of research analysts must be reviewed and approved at least annually by a committee that reports to the member firm's board of directors (or if none exists, a senior executive officer). The Amended Equity Rule prohibits representation on the committee by any personnel from the investment banking department, while the New Debt Rule prohibits investment banking and principal trading personnel from any input into the compensation of debt research analysts. Sales/trading personnel may provide input to debt research management in order to convey customer feedback (as long as research management makes the final compensation decision, subject to review and approval by the compensation committee).
- **Information barriers and institutional safeguards:** The New Research Rules explicitly require that member firms establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking services or other persons, including sales and trading personnel, who might be biased in their judgment or supervision.
- **Prohibition on retaliation:** The New Research Rules require that firms extend their anti-retaliation policies beyond investment banking personnel so that all firm employees are prohibited from directly or indirectly retaliating or threatening retaliation against research analysts employed by the member firm or its affiliates as a result of an adverse, negative or otherwise unfavorable research report written, or public appearance made, by the research analyst.
- **Personal trading:** The New Research Rules broaden the existing requirements with respect to personal trading by research analysts, supervisors of research analysts and associated persons

with the ability to influence the content of research reports in securities, derivatives and funds whose performance is materially dependent upon the performance of securities covered by the research analyst. The New Research Rules maintain the prohibition currently in place for equity research analysts restricting them from trading against their most recent recommendations and, in the case of the Amended Equity Rule, receiving pre-IPO shares in their coverage area. However, the New Research Rules permit member firms to define financial hardship circumstances, in which they will permit a research analyst to trade in a manner inconsistent with his or her most recently published recommendation. In addition, the New Research Rules provide that FINRA will not consider a research analyst account to have traded in a manner inconsistent with a research analyst's recommendation where a member firm has instituted a policy that prohibits any research analyst from holding securities (or options on or derivatives of such securities) of the companies in the research analyst's coverage area so long as the member firm establishes a reasonable plan, which is approved by the member firm's legal or compliance department, to liquidate such holdings in a manner consistent with the new rules.

- **Promises of favorable coverage:** Consistent with the existing equity research rules, the New Research Rules 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.
- **Joint due diligence:** FINRA interprets the overarching principle requiring member firms to, among other things, establish, maintain and enforce written policies and procedures that address the interaction between research analysts and those outside of the research department, including investment banking and sales and trading personnel, subject companies and customers, to prohibit due diligence by research analysts in the presence of investment banking personnel prior to the selection of the underwriters for an investment banking services transaction.⁵
- **Other interactions with investment banking:** The New Research Rules also prohibit (1) investment banking personnel from directing a research analyst to engage in sales or marketing efforts related to any investment banking services transaction or any communication with current or prospective customers about an investment banking services transaction, and (2) three-way meetings between research analysts and customers in the presence of investment banking personnel or company management about an investment banking transaction. Furthermore, any written or oral communication by a research analyst with current or prospective customers or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading.

Content and Disclosure Requirements

The New Research Rules incorporate many of the content and disclosure requirements currently in effect. The following is a summary of the areas where the New Research Rules diverge:

⁵ In the case of equity research analysts, FINRA has indicated that this prohibition does not apply to EGCs.

- **Reliable information:** A member firm must establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in its research reports are based on reliable information.
- **Conflict disclosure:** The catch-all provision requiring disclosure of material conflicts in any research report that a research analyst knows or has reason to know of at the time of the publication or distribution of a research report will now also require disclosure of material conflicts in any research report that an associated person of the member firm with the ability to influence the content of a research report knows or has reason to know of at the time of the publication or distribution of a research report.
- **Material non-public information exception:** The exception allowing disclosure to be omitted from research reports to the extent it would reveal material non-public information regarding specific potential future investment banking transactions of the subject company has been broadened so that this exception applies to any specific potential future investment banking transactions, not just those involving the subject company.

Distribution of Research Reports

- **Prohibition on selective dissemination:** Member firms are required to establish policies and procedures reasonably designed to ensure that a research report is not distributed to internal trading personnel or a particular customer or class of customers before other customers that the member firm has previously determined are entitled to receive the report. However, firms may provide different research products and services to different classes of customers so long as the differentiation of products is not based on the timing of receipt of a recommendation or rating or other potentially market moving information.
- **Third-party research reports:** A member firm may not distribute third-party research if it knows or has reason to know such research is not objective or reliable. Member firms must ensure that any third-party research they distribute contains no untrue statement of material fact and is otherwise not false or misleading. For the purpose of this requirement, a member firm's obligation to review a third-party research report extends to any untrue statement of material fact or any false or misleading information that should be known from reading the research report or is known based on information otherwise possessed by the member firm. The member firm must also accompany third-party research with disclosure of any material conflict of interest that can reasonably be expected to have influenced the member firm's choice of a third-party research provider or the subject company of a third-party research report.
- **Independent third-party research reports:** The above requirements applicable to third-party research reports do not, for the most part, apply to "independent third-party research reports."⁶ Member firms are not required to review independent third-party research prior to distribution. Further, member firms are not required to include certain third-party disclosures, including those

⁶ "Independent third-party research report" means a third-party research report, in respect of which the person producing the report: (1) has no affiliation or business or contractual relationship with the distributing member or that member's affiliates that is reasonably likely to inform the content of its research reports; and (2) makes content determinations without any input from the distributing member or that member's affiliates.

discussed above, if the research is made available by the member firm (1) upon request, (2) through a member firm maintained website, or (3) to a customer in connection with a solicited order in which the registered representative has informed the customer, during the solicitation, of the availability of independent research on the solicited security and the customer requests such independent research.

Exemptions

- **Institutional debt research:** The New Debt Rule exempts debt research reports that will only be distributed to institutional investors from the majority of its provisions, provided that certain disclosure and other requirements are satisfied. In order for research to qualify as “institutional research,” member firms are required to limit the distribution of the research to qualified institutional buyers (“QIBs”) (as defined in Rule 144A under the Securities Act) and other “institutional accounts” (as defined in FINRA Rule 4512(c)). Debt research reports can be distributed to QIBs where the QIB has either provided affirmative consent to the member firm or not contacted the member firm to request that institutional research reports not be provided to the institutional investor. Other institutional investors may receive institutional debt research only by providing member firms with affirmative written consent.
- **Limited investment banking activity and limited principal trading activity:** The New Research Rules provide that firms that engage in minimal investment banking activity (i.e., firms that over the previous three years, on average per year, have (1) participated in 10 or fewer investment banking transactions as manager or co-manager and (2) generated \$5 million or less in gross revenue from those transactions) are exempt from the provisions prohibiting investment banking personnel (and, in the case of the New Debt Rule, sales/trading and principal trading personnel) from being involved in pre-publication review of research reports, having input on coverage decisions, having supervision and control over research analysts and budget and compensation decisions and the provisions requiring the establishment of information barriers or other institutional safeguards as they relate to the review or oversight by (but not pressure by) persons engaged in investment banking services activities or other persons who might be biased in their judgment or supervision. In addition to these exemptions, the New Debt Rule also includes substantially similar exemptions for firms with limited principal trading activity (i.e., firms (1) with, in absolute value on an annual basis, trading gains or losses on principal trades in debt securities \$15 million or less over the previous three years, on average per year, and (2) that employ fewer than 10 debt traders).
- **General exemptive authority:** The New Research Rules provide FINRA with the authority, in exceptional and unusual circumstances, to conditionally or unconditionally grant an exemption from any requirement of the New Research Rules for good cause to the extent the exemption is consistent with the purpose of the New Research Rules, the protection of investors and the public interest.

Additional Changes

- **Annual attestation requirement:** FINRA has eliminated the annual attestation requirement that is currently in place, which requires member firms to attest annually that it has in place written supervisory policies and procedures reasonably designed to achieve compliance with the relevant rules. Although this requirement is not included in the Amended Equity Rule, FINRA has indicated

that existing FINRA Rule 3110, which requires member firms to establish and maintain a system of supervision reasonably designed to achieve compliance with securities laws and regulations and FINRA Rules, continues to apply.

- **Registration of research analysts:** In order to provide relief from the registration requirements for those who produce research reports on an occasional basis, NASD Rule 1050(b) and Incorporated NYSE Rule 344.10 have also been amended to change the definition of “research analyst” to limit its scope to persons who produce research reports and whose primary job function is to provide investment research. FINRA points out that although these requirements only apply to equity research analysts, FINRA is considering whether debt research analysts should be subject to similar requirements.

Implementation Schedule

The Amended Equity Rule becomes effective in two stages: the provisions relating to quiet periods, the registration of research analysts, the general exemptive authority, the annual attestation requirement and divesting research analyst holdings will be effective on September 25, 2015, with the remainder of the provisions becoming effective on December 24, 2015. The New Debt Rule becomes effective on February 22, 2016.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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