



FINRA'S NEW RESEARCH RULES: HOW CCOs CAN PREPARE

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The Financial Industry Regulatory Authority has adopted amendments to its equity research rules and an entirely new debt research rule, which covers research on corporate and sovereign debt, but not municipal or U.S. Treasury securities or security-based swaps.

In order to implement the new requirements, chief compliance officers and other compliance professionals will need to revise existing policies and procedures, and adopt new ones. In some cases—particularly for firms that publish debt research—organizational changes within the firm may be required, including, potentially, modifying reporting lines, compensation processes and communication flows.

THE NEW RULES

The major differences between FINRA's existing equity research rules, NASD Rule 2711 and Incorporated New York Stock Exchange Rule 472—referred to collectively as the “current equity rules”—and new FINRA Rule 2241 (the “new equity rule”) and Rule 2242 (the “debt rule”) include:

“Policies and procedures” approach

Member firms will need to adopt policies and procedures designed to meet certain general overarching objectives, but which also contain specific minimum elements. The minimum requirements are similar to those in the current equity rules, but with important differences.

Blackout periods

Firms may reduce the blackout periods during which they may not publish or distribute equity research reports and equity analysts may not make public appearances relating to the issuer: the current 40-day blackout period for initial public offerings can be shortened to 10 days, and the current 10-day blackout period for secondary offerings can be shortened to three days. FINRA has eliminated the requirement to establish a blackout period around the time of lock-up expiration. No research or public appearance blackouts are required for debt research or, as under the current equity rules, for equity research pertaining to “emerging growth companies.”

Exemption for institutional debt research

Debt analysts will need to be separated in various ways from investment banking (IB), sales and trading (S&T) and principal trading (PT) departments and personnel. But research provided solely to certain consenting or deemed consenting eligible institutional investors will be exempted from many provisions of the debt rule, provided that certain disclosure and other requirements are met.

Pre-publication review

IB personnel will no longer be able to conduct pre-publication review for factual verification for either equity or debt research.

Compensation

Both new rules will carry over the current equity rules' prohibition on basing analyst compensation on specific IB transactions or contributions to the firm's IB business. The debt rule will also prohibit the consideration of specific trading transactions or contributions to the firm's PT activities.

Disclosures

Both new rules will require firms to establish policies and procedures to ensure that purported facts in research reports are based on reliable information and will expand the existing “catch-all” disclosure for research reports to cover material conflicts of interest known by any associated person of the firm with the ability to influence the contents of a research report.

Information barriers

Both new rules explicitly require firms to maintain information barriers or other safeguards reasonably designed to ensure that research analysts are insulated from the review, pressure or oversight by persons who might be biased in their judgment or supervision, including IB and S&T personnel, and, in the case of the debt rule, PT personnel.

Personnel registration

FINRA has modified the definition of “research analyst” in its equity research analyst registration rule to limit it to associated persons whose primary job function is to provide investment research and who are primarily responsible for the preparation of the substance of a research report or whose name appears on a research report. This provides relief for persons who prepare equity research reports only on an occasional basis. The debt rule does not include any specific qualification requirements for debt research analysts.

Retaliation

Both new rules will extend the current anti-retaliation prohibition to employees other than IB personnel.

Annual attestation

The current research-specific annual attestation requirement will be eliminated.

The new rules do not supersede the 2003 global research settlement (as amended in 2010), which imposes on many of the largest broker/dealers a structural separation between the firms' IB and

equity research units. Nor will the new rules affect the obligations of firms under Securities and Exchange Commission Regulation AC. The new rules carry over the small firm exemption from the current equity rules, with certain changes.

The debt rule becomes effective Feb. 22, 2016. Most provisions of the new equity rule become effective Dec. 24, 2015, though certain aspects become effective Sept. 25, 2015. These include: the new, shorter blackout periods; the elimination of the research-specific annual attestation requirement; and the modification of the research analyst definition in the equity analyst registration rule.

Firms that rely on the institutional debt research exemption may send institutional debt research to certain institutional accounts (except natural persons) without obtaining the otherwise necessary consent until July 16, 2016.

YOUR TO-DO LIST

Despite the very significant overlap between the current equity rules and the minimum requirements in the new rules, compliance professionals have many tasks ahead of them to implement the new requirements, including the following:

✓ **Revise, and in some cases establish new, equity research policies and procedures**

Compliance professionals at firms that produce equity research will need to consider if their firm's existing policies and procedures and written supervisory procedures, or WSPs, satisfy the overarching principles established in the new rules—such as the promotion of objective and reliable research that is reflective of analysts' truly held opinions and the prevention of the use of research or analysts to manipulate or condition the market or favor the firm's interests or its current or prospective customers—and address certain specific minimum requirements, some of which are new or modified—such as certain modified disclosure requirements and a broader anti-retaliation prohibition.

✓ **For firms that produce debt research, adapt existing policies and procedures to cover debt, or establish new ones**

Compliance professionals at firms that produce debt research will need to evaluate whether it is practical to graft new debt-specific provisions onto existing policies, procedures and WSPs. If it is not, they will need to establish an entirely new set of provisions for debt research.

The policies, procedures and WSPs for debt research will generally parallel those for equity research, but will need to reflect certain key differences and nuances. For instance, certain requirements are extended under the debt rule to S&T and

PT personnel, such as the general prohibition on internal pre-publication review, and the disclosure requirements in the new equity and debt rules are not entirely identical.

✓ **For firms relying on the institutional debt research exemption, provide notices, obtain consents and ensure disclosures added, among other things**

Firms that use the institutional debt research exemption will be subject to a lighter touch set of debt research requirements. However, compliance professionals at those firms will still need to develop several processes. They will have to track affirmative or negative consents from qualified institutional buyers and obtain and monitor affirmative written consents from other institutional accounts.

In addition, they will need to make sure that appropriate disclosures are attached to institutional debt research and address various components of the debt rule that apply regardless of the use of the exemption; for example, the general prohibition on pre-publication review by IB, PT and S&T personnel.

✓ **Identify and effectively manage “emerging” conflicts**

When modifying existing or developing new policies and procedures under both rules, compliance personnel will need to identify proactively and manage effectively both existing and *emerging* conflicts of interest in order to satisfy the new requirements and FINRA’s stated expectations.

Compliance personnel will need to think broadly about what conflicts may potentially arise as a result of business changes, including new research products, affiliations and distribution methods—and how to manage them effectively.

✓ **Examine and reengineer certain reporting lines, information barriers, analyst evaluation and compensation practices and research budget processes**

Compliance personnel will need to analyze and, in some cases, firms may need to change certain reporting lines, organizational practices and decision-making processes in light of certain aspects of the new rules. For instance, the new equity rule requires firms to maintain information barriers or other safeguards that ensure analysts are insulated from the review, pressure or oversight by IB and other personnel—including S&T—who might be biased in their judgment or supervision.

Compliance personnel at firms that produce both equity and debt research will have to manage certain inconsistencies between the two rules. For example, debt-related barriers are required between the research function and IB, S&T and PT, with certain modifications for firms relying on the institutional debt exemption.

✓ **Ensure satisfaction of disclosure requirements**

Compliance personnel will need to ensure that firms are providing compliant disclosures concerning certain conflicts of interest and other issues relating to the firm—and, in some cases, its affiliates. For example, under both rules, firms must disclose those material conflicts that are known (or should be known) to analysts and any “associated person with the ability to influence the contents of a research report”—i.e., any person who is required to review the content of the research report or has exercised authority to review or change the report before its publication or distribution.

To comply with this expanded “catch-all” disclosure requirement, compliance personnel will need to ensure that anyone who has exercised his or her

authority to review or change a research report prior to its publication is taken into account for purposes of conflicts disclosures.

✓ **Evaluate research distribution channels**

Compliance professionals will need to examine their firms’ research distribution channels to ensure that research is not distributed selectively to internal trading personnel or particular customers in contravention of the new rules and FINRA guidance.

Firms may provide different research products and services to different classes of customers, provided they have disclosed to their other customers receiving a research product that the firm’s alternative research products and services may reach different conclusions or recommendations that could impact the price of the security. However, compliance personnel will need to establish methods to ensure their firms do not, among other things, differentiate a research product based on the timing of receipt of a recommendation, rating or other potentially market moving information.

✓ **Update training**

The new rules expand firms’ obligations and impose several new requirements and restrictions on research-related activities—including an entirely new set of requirements on debt research. As a result, compliance personnel will need to make a number of changes to their firms’ training programs and, in many cases, conduct new training.

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