

INDUSTRY VIEW

IS B/D DESK COMMENTARY DEAD?

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Brokers have for many years produced on the trading desk and distributed to customers written “desk commentary” without all of the procedural safeguards applicable to research. During that time, the **Financial Industry Regulatory Authority** has never clarified where the line between research and desk commentary is drawn. But industry professionals have said that some FINRA examiners have recently made comments to several firms that have caused concern because they have been seen as implying a robust view of which communications are deemed to be research reports.

The timing of this concern could not be worse: FINRA’s recently amended equity research rules became effective in late December, and its new debt research rule has a Feb. 22, 2016 compliance date (Compliancereporter.com, 9/15). Continuing uncertainty may result in firms restricting desk communications and restructuring their compliance programs for debt research, on a fire drill basis, to rely on a procedurally cumbersome “institutional exemption.”

We believe FINRA should take action to avoid this outcome. Desk commentary has a legitimate and valuable role. Such communications allow the people closest to the market—the trading desk—to convey trading ideas, market color and developments in the relative value of securities to customers in a concise and timely fashion. Although an overly permissive regime for desk commentary could run the risk of subverting the compliance scheme around “real” research, we believe this concern can be managed through content limitations, disclaimers and restrictions concerning the potential recipients.

In order to prevent a chilling effect on the continued production of desk commentary, we propose that FINRA move quickly to:

- Provide more definitive guidance regarding what communications constitute “research reports;”
- Establish a tailored safe harbor for desk commentary; and
- Afford members additional time to implement the new debt research rule.

We believe FINRA can take these actions without compromising investor protection.

RESEARCH RULES

FINRA’s research rules impose extensive requirements on member firms’ equity research activities, including: prohibiting the supervision or control of research analysts by a firm’s investment banking (IB) department; restricting pre-

publication review of reports by non-research personnel and issuers; constraining IB input into analyst compensation and research coverage; and prohibiting equity analysts from soliciting IB business. Equity research must be prepared by specially qualified personnel.

In August 2015, FINRA adopted new Rule 2241, which amended its then-existing equity research rules, and for the first time established a debt research rule, Rule 2242. The new equity rule, which became fully effective in December 2015, carries over most of the requirements of FINRA’s previous equity rules. Firms must establish information barriers and other safeguards to ensure research analysts are insulated from the review, pressure or oversight by IB and any other personnel who might be biased in their judgment or supervision, including sales and trading.

The debt rule, which is scheduled to become effective on Feb. 22, 2016, reflects the same general requirements as the new equity rule, but with some modifications. For example, the debt rule extends certain requirements to firms’ principal trading functions and, in some cases, sales and trading personnel and departments, including the information barrier requirement, the prohibition on supervision of analysts and the prohibition on pre-publication review.

The debt rule also contains an “institutional exemption,” under which debt research provided solely to certain consenting eligible institutional investors will be exempted from some requirements, such as the information barrier requirement (except with respect to pressuring of analysts) and the prohibition on IB, principal trading and sales and trading supervision of analysts—provided the research reports contain a disclosure.

WHAT IS A RESEARCH REPORT?

Both the existing and new research rules apply to “research reports” and “research analysts.” FINRA defines a research report as any written—including electronic—communication that includes an analysis of equity/debt securities, and provides information reasonably sufficient upon which to base an investment decision. A specific recommendation is not an essential element of a research report.

While FINRA excludes communications distributed to fewer than 15 persons, a firm cannot “cleanse” a document merely by affixing a disclaimer on it that it is not research.

Any employee, regardless of title or department, is considered to be a research analyst if he or she prepares a research report. The extensive requirements that apply to research analysts mean the stakes are high for a firm if there is uncertainty

regarding whether or not an employee is producing a document that may cross the line into being a research report.

DESK COMMENTARY

Desk commentary generally refers to a range of written materials that sales and trading personnel generate and distribute to their existing and prospective customers. Some firms have analysts who sit with other sales and trading personnel and gather, synthesize and interpret market and trade data for their market-making and trade execution functions.

Desk personnel often send this information to their existing and prospective customers—both individually and in groups. Desk personnel also send emails and messages to customers with articles, links and alerts, which often also include market color and trading ideas. Many investors value desk commentary because it reflects timely information that can only be obtained from someone who is closely associated with daily trading activity.

Over the years, many FINRA members have been comfortable taking the position that most desk commentary does not constitute research reports on the basis that its relative brevity and lack of detailed analysis would not, alone, be a sufficient basis on which to form an investment decision. But just as firms have begun gearing up to implement FINRA’s new research rules, industry professionals have expressed concern that the generally understood boundary lines around what constitutes a research report may have changed, even though FINRA’s definition of the term has not formally changed.

Industry professionals have said that, during a recent examination sweep, FINRA examiners asserted with a small number of firms what the industry officials saw as an aggressive position concerning what communications by non-research personnel constitute research reports. It appears to us that in some cases the examiners may have either effectively read out the “analysis” element of the definition or adopted an expansive interpretation of when there is “information reasonably sufficient upon which to base an investment decision.”

SOME CONCERNS

If desk commentary is deemed research and its authors deemed research analysts, then the application of the new equity rule and the debt rule will likely force many firms to either stop distributing desk commentary or limit it to groups of 14 or fewer customers.

The institutional exemption provides some glimmer of hope for a third approach to desk commentary relating to debt securities. On the

surface, it gives firms latitude to produce desk commentary without the full range of restrictions otherwise applicable to debt research. But firms seeking to use it have their work cut out. The institutional exemption's consent mechanics—requiring positive consents from some institutions and institutional suitability affirmations from others—have until now led many firms to dismiss the usefulness of the exemption.

Moreover, firms that have considered using the exemption for desk commentary or other customer communications that are more clearly research reports fear second guessing by FINRA's staff regarding the adequacy of "anti-pressuring" safeguards required by the institutional exemption and policies and procedures to harmonize the purported liberalizations of the institutional exemption with the requirements of FINRA Rule 5280, which concerns trading ahead of research reports. Of course, a profound limitation to using the institutional exemption for desk commentary is that it only applies to debt research and not equity research.

Overall, it is likely that many FINRA members will conclude that using the institutional exemption is not a practical way to address uncertainty regarding the status of desk commentary. Even firms that seek to fit desk commentary within the exemption may now be "behind the eight ball" in terms of implementation, since most firms previously discarded the possibility of relying on the exemption for debt research and now must scramble to be ready for Feb. 22.

REGULATORY RISKS

Undoubtedly, the production and distribution of desk commentary is not free from conflicts of interest. Many firms have various relationships with the issuers covered in the communications. Moreover, firms may trade such securities for their own accounts and on behalf of clients.

But the customary recipients of desk commentary—sophisticated institutional investors—generally understand that desk personnel may not be bias-free and that desk commentary is not necessarily impartial. Further, such investors are capable of exercising independent judgment in making investment decisions and can incorporate desk commentary into their decision making selectively. Appropriate disclosures can further aid investors in evaluating potential conflicts.

The distinction between desk commentary and traditional research reports—and the need to preserve firms' ability to produce desk commentary—have been recognized in other contexts:

- **The Commodity Futures Trading Commission** rules governing derivatives intermediaries' research activities exclude from their research report definitions any communications generated by an employee of a business trading unit that are conveyed as a solicitation for entering into a derivatives transaction, and are conspicuously identified as such. Communications that meet this

exclusion fall outside the rules' structural safeguards that separate research personnel from trading and clearing functions.

- The "global research analyst settlement" excludes from its research report definition any analysis prepared by a registered sales person or trader who is not principally engaged in the preparation or publication of research reports. Communications that meet this exclusion fall outside of the settlement's requirements to separate settling firms' equity research and IB units.

It is also worth noting that broker/dealer desk communications are subject to FINRA's general communications rule (Rule 2210), which requires all member communications to comply with principles of fair dealing and good faith and among other things to have a sound basis. They are also subject to FINRA's Rule 2010, which requires members to conduct all aspects of their business in accordance with just and equitable principles of trade, as well as the anti-fraud and anti-manipulation rules under the federal securities laws.

SUGGESTIONS

FINRA should quickly take steps to avoid confusion among member firms, and to allow desk commentary to be produced on a basis that does not compromise investor protection.

Provide general interpretive guidance

FINRA should:

- *Issue guidance on what constitutes an "analysis."* Ideally, FINRA should confirm that it applies the standard dictionary definition of analysis—i.e. the careful study of something to learn about its parts, what they do and how they are related to each other. In addition, FINRA should identify factors that would be indicative of an analysis of a security or issuer; for example, a discussion of a company's products and services, management, strategies, competition and regulatory environment. FINRA should also clarify that the mere recitation of facts upon which a statement or recommendation is based does not, alone, constitute an analysis.
- *Identify other relevant factors.* FINRA should clarify that the length and detail of a communication are relevant to the determination of whether the communication includes an analysis. A brief and informal commentary is generally not reflective of the careful study of something, so it should not be regarded as an analysis. FINRA should also confirm that the use of certain conditional statements may cut against a finding that a communication is a research report; for example, "if you believe the outcome will be A, then B would be an optimal way to position yourself" or "if you agree with thesis X, then anything below \$Y would be an ideal entry point."
- *Provide examples.* FINRA should provide examples of how it analyzes different types of written communications under each element

of the definition and identify how the analysis may differ for various product types.

Desk commentary safe harbor

The infinite forms that written communications may take mean that any FINRA guidance will almost certainly not cover all possibilities. Ultimately, whether or not a communication will be deemed a research report will be based on the "facts and circumstances." As a result, and in light of the present uncertainty, it is likely that some firms will not be comfortable relying on general guidance in all cases. The institutional exemption is also not going to be an adequate or practical way forward for many firms, given its various limitations.

It does not serve FINRA's policy goals to in effect prohibit or strongly discourage firms from distributing desk commentary to groups of 15 or more customers. Therefore, FINRA should develop a targeted exemption from the definition of research report for desk commentary concerning debt and equity securities distributed solely to sophisticated institutional clients where such communication is:

- Distributed solely to institutional accounts, as defined in FINRA Rule 4512(c);
- Prepared by a sales person or trader who is not principally engaged in the preparation or publication of research reports, is not assigned to the firm's research department and is not identified or marketed in any way as a member of the firm's research department; and
- Neither labeled as, nor represented to be, a research report, nor represented to be a product of the firm's research department.

FINRA should also require the use of a prominent, general disclaimer that the communication was prepared by desk personnel outside of the firm's research department, is intended solely for institutional investors and is not subject to all of the independence and disclosure standards and other requirements applicable to research reports under FINRA's research rules.

The disclosure should also state that the contents of the communication are not independent of the firm's proprietary interests, and that the firm may trade covered securities for its own account and on behalf of certain clients. FINRA might consider as additional conditions to a safe harbor the absence of a specific recommendation and the satisfaction of criteria directed at the length of analytical content.

Timing relief

Finally, because of the uncertainty regarding the scope of the research report definition, we believe it would be beneficial for FINRA to extend the effective date for the debt rule to provide firms with the opportunity to implement it following the issuance of any interpretive guidance.

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