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New and Proposed Research Rules Create Compliance Challenges for Banks

BY LANNY A. SCHWARTZ AND JEFFREY T. DINWOODIE

There have been a number of important developments and proposals regarding securities and derivatives research that complicate regulatory compliance and will likely affect the structure of research and other functions at multiservice banks. In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and agency rules create new research-related requirements for swaps market intermediaries, and the Financial Industry Regulatory Authority (FINRA) has proposed new requirements for debt research. These initiatives *extend* to new instruments the same types of safeguards against potential conflicts of interest and other abuses that have been developed for equity research, though with important differences. By contrast and somewhat paradoxically, the Jumpstart Our Business Startups Act (the JOBS Act) *relaxed* limitations regarding the publication of research reports concerning smaller companies, but not for larger and more established issuers.

This article discusses the compliance challenges that financial institutions must contend with as they engineer new compliance processes and organizational structures to accommodate evolving research-related regulatory mandates that differ by product and issuer type.

LANNY A. SCHWARTZ *is a partner at Davis Polk & Wardwell in New York.* JEFFREY T. DINWOODIE *is an associate in the firm's Washington, D.C., office. Both authors work in the firm's financial institutions group.*

Development of Current Framework

The current regulatory framework governing securities research developed largely in the aftermath of the tech stock bubble and corporate scandals of the late 1990s and early 2000s, as regulators grew increasingly concerned about the integrity and objectivity of equity research. In 2002, the National Association of Securities Dealers (NASD n/k/a FINRA) and the NYSE (together, the self-regulatory organizations, or SROs) adopted equity research rules (SRO Equity Research Rules), which:

- limit the relationships and communications between a firm's research and investment banking departments;
- restrict prepublication review of research by investment banking personnel and subject companies;
- restrict investment banking input into analyst compensation decisions;
- prohibit analysts from participating in efforts to solicit investment banking business, and bar investment banking personnel from directing an analyst to engage in

solicitation or marketing efforts relating to an investment banking services transaction;

• impose research quiet periods following an IPO, and around the termination and expiration of lock-ups; and

• mandate conflict disclosures.

Shortly thereafter, the U.S. Securities and Exchange Commission (SEC) adopted Regulation AC, which requires research analysts to certify the truthfulness of the views they express in research reports and public appearances, and to disclose whether they have received any compensation related to their recommendations. And, in 2003, the SEC, the SROs and state regulators entered into a settlement (the Global Settlement)—which remains in place, in modified form, today—with 10 of the nation's largest securities firms, imposing structural reforms that further separated the settling firms' equity research and investment banking units.

In the wake of the recent financial crisis, Congress and regulators have again focused on the regulation of research.

New Swap Research Requirements

In order to address potential conflicts of interest between swap intermediaries' trading and clearing functions and swaps and commodities research, Dodd-Frank requires swap intermediaries, including swap dealers and security-based swap dealers, to establish structural safeguards to separate swaps research personnel from colleagues whose involvement in pricing, trading or clearing activities might potentially bias their judgment.

The U.S. Commodity Futures Trading Commission's (CFTC) rules implementing this requirement for swap dealers:

• limit the relationships and communications between derivatives research units and "nonresearch personnel" of the firm and its affiliates;

• prohibit employees of the business trading unit or clearing unit of the firm and its affiliates from having influence or control over the evaluation or compensation of derivatives research analysts (although they may communicate customer feedback); and

• impose certain conflicts disclosures.[1]

Swap dealers' research activities are also subject to National Futures Association rules, including content and recordkeeping requirements.

The SEC's rules for security-based swap dealers have not yet been finalized. However, the agency's *proposed* rules do not entirely align with the CFTC's, and are far less prescriptive.

Some compliance challenges include:

The need to incorporate affiliates into swap dealer compliance programs. Swap dealers and their affiliates must develop compliance programs and systems that extend informational partitions to affiliates preparing derivatives research on behalf of the swap dealer. In addition, since the limitations on nonresearch personnel supervising derivatives research analysts and influencing their compensation extend to the swap dealer and its affiliates, firms must potentially reengineer relevant group-wide supervisory and compensation review structures, even within parent companies and affiliates that are not regulated by the CFTC.

Prompted in part by allegations of misconduct associated with the sale of auction rate securities, FINRA has **proposed debt research requirements** for member broker-dealers.

New requirements imposed on certain equity research analysts. Some equity research analysts in multiservice financial institutions will become subject to the CFTC rules when they also act as derivatives research analysts, including, for example, when they contribute to a multiproduct report where securities and derivatives are discussed together. Because the CFTC's rules impose different information partitions and supervisory and compensation review structures than those contained in the SRO Equity Research Rules and the Global Settlement, firms will need to ensure that both sets of rules are satisfied with respect to research analysts who cover both types of products.

Potential inconsistencies between CFTC and SEC derivatives research rules. The derivatives research rules applicable to swap dealers and security-based swap dealers are likely not going to be completely harmonized. This could create compliance challenges for dually-registered swap/security-based swap dealers. Potentially, the same research analyst preparing a report on interest rate swaps (which are regulated by the CFTC) and single-name credit default swaps (which are regulated by the SEC) involving the same underlying company will be subject to different requirements and procedures.

Proposed Debt Research Rules

Prompted in part by allegations of misconduct associated with the sale of auction rate securities, FINRA has *proposed* debt research requirements for member broker-dealers.

The proposed rules (which will not become effective until approved by FINRA and the SEC) would effectively extend many existing structural safeguards and disclosures of the SRO Equity Research Rules, as enumerated above, to debt research, with a number of important caveats. For example, FINRA's proposal would address conflicts between debt research and sales and trading functions, whereas the existing SRO Equity Research Rules are primarily limited to conflicts between research and investment banking. There are limited exceptions to certain requirements for firms with relatively insignificant investment banking and debt sales and trading functions.

A broker-dealer would be subject to lighter touch regulatory requirements when distributing debt research to institutional investors that have consented to receiving research that has not been subjected to the full range of compliance procedures. In the case of the largest and most sophisticated investors, consent may be procured through a negative consent process. With regard to such "institutional research," a broker-dealer would only have to comply with a subset of the new requirements, including:

• restrictions on prepublication review of debt research by investment banking personnel and subject companies;

• prohibitions on debt research analysts participating in the solicitation of investment banking business, road shows and other marketing and on investment banking personnel directing a debt research analyst to engage in sales and marketing efforts concerning an investment banking transaction;

• bars on retaliation and promises of favorable debt research; and

• a mandated "health warning" disclosure.

If and when they are finalized, FINRA's proposed debt research requirements would supplant the Securities Industry and Financial Markets Association's *volun-*

tary "guiding principles" concerning fixed income research, which have been adopted to varying degrees by brokerage firms.

Some compliance challenges include:

Extensive new limitations on debt research provided to retail customers and nonconsenting institutions. Firms that choose to provide debt research to retail customers and nonconsenting institutions will need to develop and implement extensive new policies and procedures, including supporting technological enhancements and training. These policies and procedures will need to address new limitations on, and requirements relating to, among other things: relationships and communications between debt research analysts and individuals outside of the research department, including investment banking, sales and trading, and principal trading personnel; prepublication review of debt research by investment banking, sales and trading and principal trading personnel and subject companies; input from certain departments and personnel into debt research analyst compensation decisions; participation of debt research analysts in efforts to solicit investment banking business; and conflict disclosures. The new structural safeguards concerning the involvement of sales and trading and principal trading functions of the firm with the debt research function may prove to be particularly difficult from a business perspective.

Dual compliance procedures for institutional and noninstitutional clients. While the securities industry has supported a "two tier" compliance approach to institutional and retail research, the proposed scheme would nonetheless add a significant layer of complexity to debt research compliance programs. Among other things, firms would initially need to engage in a significant program of soliciting and tracking affirmative consents and negative consent "opt-outs" from institutional investors. In the event that a firm chooses to distribute research to retail investors or nonconsenting institutions, as well as to consenting institutional investors, the firm will need to monitor compliance with both institutional and retail requirements, as applicable to a particular report or analyst.

Inconsistencies with derivatives research rules. Differences between FINRA's debt proposal and the derivatives research rules would also add further complexity for multiservice banks that issue research on multiple products. Given the close business connection between debt and related derivatives (including currencies, interest rate and credit products), it is likely that many debt research analysts and research departments in multiservice firms will ultimately be subject to CFTC derivatives research rules and SEC rules applicable to security-based swap dealers and research on security-based swaps (such as single name credit default swaps), as well as FINRA's debt research rules. It will be a multidimensional challenge for compliance departments and research management to police all applicable restrictions, and may prompt some firms to limit analysts' range of product coverage.

JOBS Act Liberalizations

To help facilitate capital formation for "emerging growth companies" (EGCs) (i.e., certain going public or newly public companies with less than $1 billion in total annual gross revenues), and with the ostensible intention of spurring employment growth, the JOBS Act liberalizes a number of rules relating to EGCs, including in the realm of research practices. In particular, the JOBS Act permits the publication or distribution of a research report related to an EGC prior to a proposed IPO by that company. It also permits publication or distribution of research reports related to an EGC at any time after the company's IPO or prior to the expiration date of a lock-up entered into in connection with such IPO, thus technically eliminating for EGCs the research quiet periods following IPOs and the expiration, waiver or termination of a lock-up, both of which have been central elements of the SRO Equity Research Rules (which have since been amended to conform to the JOBS Act's EGC provisions).

The JOBS Act also eliminates any SRO restrictions on analysts' participation in communications with the management of an EGC that are also attended by any other associated person of the broker-dealer who is not an analyst. However, as noted in a "Frequently Asked Questions" document released by the SEC staff in August 2012, the JOBS Act does not impact certain aspects of the SRO Equity Research Rules that address conflicts of interest between investment banking personnel and research analysts.

Finally, the JOBS Act forbids the SEC and the SROs from restricting investment banking personnel from arranging for communications between a securities analyst and a potential investor, but does not eliminate the FINRA restriction on investment bankers directing analysts to engage in marketing investment banking transactions. The SEC staff have clarified that an investment banker may provide an analyst with a list of clients for the analyst to contact at his or her own discretion and with appropriate controls, or arrange calls between analysts and clients, so long as the investment banker does not participate in the calls.

Some compliance challenges include:

Limited role of analysts in issuer management meetings. Notwithstanding any JOBS Act reforms, firms that are party to the Global Settlement remain subject to mandated firewalls between investment banking and research that are designed to prohibit communications between the two except as expressly permitted (e.g., in chaperoned or widely attended meetings). In addition, all broker-dealers must give close attention to the conduct of analysts in meetings and communications now permitted under the JOBS Act in relation to EGCs to ensure that remaining FINRA prohibitions on solicitation of investment banking business and promises of favorable research coverage are not compromised.

Conclusion

While advancing the various policy objectives of Dodd-Frank and the JOBS Act, as well as the general regulatory missions of the CFTC, the SEC and FINRA, the developments described above present considerable challenges to financial institution management and compliance personnel in regard to the development of appropriate organizational and management structures, policies and procedures and information flows. In addition, the task of educating research analysts and management regarding the increasingly Byzantine distinctions among rules that are, or will likely be, applicable to different legal entities within a financial institution, covered instruments and subject companies is formidable.

1. Dodd-Frank also requires futures commission merchants and introducing brokers to implement systems and procedures relating to research conflicts, and the CFTC's implementing rules for these mandates are analogous to those applicable to swap dealers.