

# Regulatory Notice

15-31

## Debt Research

### SEC Approves Rule to Address Conflicts of Interest Relating to the Publication and Distribution of Debt Research Reports

Effective Date: February 22, 2016

#### Executive Summary

The SEC approved the adoption of FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) to address conflicts of interest relating to the publication and distribution of debt research reports.<sup>1</sup> Rule 2242 becomes effective on February 22, 2016.

The rule text is available at [www.finra.org/notices/15-31](http://www.finra.org/notices/15-31).

Questions regarding this *Notice* should be directed to:

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#### Background and Discussion

Rule 2242 is intended to foster objectivity and transparency in debt research and to provide investors with more reliable and useful information to make investment decisions. The rule adopts a tiered approach that, in general, provides retail debt research recipients with extensive protections similar to those provided to recipients of equity research under FINRA rules, with modifications to reflect differences in the trading of debt securities.<sup>2</sup> At the same time, the rule provides broad exemptions for debt research distributed solely to eligible institutional investors.

## August 2015

#### Suggested Routing

- ▶ Compliance
- ▶ Fixed Income
- ▶ Investment Banking
- ▶ Legal
- ▶ Research
- ▶ Senior Management
- ▶ Trading

#### Key Topics

- ▶ Conflicts of Interest
- ▶ Fixed Income
- ▶ Principal Trading
- ▶ Research Analysts
- ▶ Research Reports

#### Referenced Rules & Notices

- ▶ FINRA Rule 0140
- ▶ FINRA Rule 2111
- ▶ FINRA Rule 2210
- ▶ FINRA Rule 2241
- ▶ FINRA Rule 2242
- ▶ FINRA Rule 4512
- ▶ FINRA Rule 6710
- ▶ FINRA Rule 9600 Series

The rule differs from the equity research rule in three key respects. First, it sets out prohibited and permissible communications between debt research analysts and principal trading and sales and trading personnel, taking into account the need to ration a debt research analyst's resources among the multitude of debt securities, the limitations on price discovery in the debt markets, and the need for trading personnel to perform credit risk analyses with respect to current and prospective inventory. Second, as noted above, the rule exempts debt research provided solely to institutional investors from many of the structural protections and prescriptive disclosure requirements that apply to research reports distributed to retail investors, but adds a "health warning" requirement. Third, in addition to the exemption for limited investment banking activity found in the equity research rule, the rule also contains an exemption for limited principal trading activity from the review, supervision, budget and compensation provisions in the rule related to principal trading activity.

### Definitions

Most of the defined terms in the rule closely follow the defined terms in the equity research rule, with minor changes to reflect their application to debt research. The following are the rule's key debt-related definitions:

Rule 2242(a)(1) defines "debt research analyst" as an associated person who is primarily responsible for, and any associated person who reports directly or indirectly to a debt research analyst in connection with, the preparation of the substance of a debt research report, whether or not any such person has the job title of "research analyst."

Rule 2242(a)(3) defines "debt research report" to include any written, including electronic, communication that includes an analysis of a debt security or an issuer of a debt security and that provides information reasonably sufficient upon which to base an investment decision, excluding communications that solely constitute an equity research report under Rule 2241. A "debt research report" would not include communications that:

- ▶ constitute statutory prospectuses that are filed as part of the registration statement;
- ▶ constitute private placement memoranda and comparable offering-related documents, other than those that purport to be research;
- ▶ are limited to the following, if they do not include an analysis of, or recommend or rate, individual debt securities or issuers:
  - ▶ discussions of broad-based indices;
  - ▶ commentaries on economic, political or market conditions;
  - ▶ commentaries on or analyses of particular types of debt securities or characteristics of debt securities;
  - ▶ technical analyses concerning the demand and supply for a sector, index or industry based on trading volume and price;

- ▶ recommendations regarding increasing or decreasing holdings in particular industries or sectors or types of debt securities; or
- ▶ notices of ratings or price target changes, provided that the member simultaneously directs the readers of the notice to the most recent debt research report on the subject company that includes all current applicable disclosures required by the rule and that such debt research report does not contain materially misleading disclosure, including disclosures that are outdated or no longer applicable; and
- ▶ are limited to the following, even if they include an analysis of an individual debt security or issuer and information reasonably sufficient upon which to base an investment decision:
  - ▶ statistical summaries of multiple companies' financial data, including listings of current ratings that do not include an analysis of individual companies' data;
  - ▶ an analysis prepared for a specific person or a limited group of fewer than 15 persons;
  - ▶ periodic reports or other communications prepared for investment company shareholders or discretionary investment account clients that discuss individual debt securities in the context of a fund's or account's past performance or the basis for previously made discretionary investment decisions; or
  - ▶ internal communications that are not given to current or prospective customers.

Rule 2242(a)(4) defines the term "debt security" as any "security" as defined in Section 3(a)(10) of the Securities Exchange Act of 1934 (SEA), except for any "equity security" as defined in Section 3(a)(11) of the SEA, any "municipal security" as defined in Section 3(a)(29) of the SEA, any "security-based swap" as defined in Section 3(a)(68) of the SEA, and any "U.S. Treasury Security" as defined in paragraph (p) of FINRA Rule 6710.

Rule 2242(a)(5) defines the term "debt trader" to include a person, with respect to transactions in debt securities, who is engaged in proprietary trading or the execution of transactions on an agency basis.

### Identifying and Managing Conflicts of Interest

Rule 2242(b)(1) contains an overarching provision that requires members to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to the preparation, content and distribution of debt research reports, public appearances by debt research analysts, and the interaction between debt research analysts and persons outside of the research department, including investment banking, sales and trading and principal trading personnel, subject companies and customers. The rule draws a distinction between sales and trading personnel<sup>3</sup> and persons engaged in principal trading activities, imposing greater restrictions on the latter

group due to the greater magnitude of the conflict between those persons and debt research analysts. Under Rule 2242(b)(2), the required written policies and procedures must be reasonably designed to promote objective and reliable debt research that reflects the truly held opinions of debt research analysts and to prevent the use of debt research reports or debt research analysts to manipulate or condition the market or favor the interests of the firm or current or prospective customers or class of customers. These provisions, therefore, set out the fundamental obligation for a member to establish and maintain a system to identify and mitigate conflicts to foster integrity and fairness in its research products and services. The required policies and procedures also must prohibit or restrict specified conduct, as set forth in more detail below.

### Prepublication Review

Pursuant to Rule 2242(b)(2)(A) and (B), the required policies and procedures must prohibit prepublication review, clearance or approval of debt research by persons involved in investment banking, sales and trading or principal trading, and either restrict or prohibit such review, clearance and approval by other non-research personnel other than legal and compliance. A member must specify in its policies and procedures the circumstances, if any, where prepublication review by other non-research personnel would be permitted as necessary and appropriate; for example, where non-research personnel are best situated to verify select facts or where administrative personnel review a research report for formatting. The policies and procedures also must prohibit prepublication review of a debt research report by a subject company, other than for verification of facts.

Sections of a draft debt research report may be provided to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or to the subject company for factual review, so long as:

1. the sections of the draft debt research report submitted do not contain the research summary, recommendation or rating;
2. a complete draft of the debt research report is provided to legal or compliance personnel before sections of the report are submitted to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company; and
3. if, after submitting sections of the draft debt research report to non-investment banking personnel, non-principal trading personnel, non-sales and trading personnel or the subject company, the research department intends to change the proposed rating or recommendation, it must first provide written justification to, and receive written authorization from, legal or compliance personnel for the change.<sup>4</sup>

The member must retain copies of any draft and the final version of such debt research report for three years after publication.

### Coverage Decisions

Rule 2242(b)(2)(C) requires that a member's written policies and procedures restrict or limit input by investment banking, sales and trading and principal trading personnel to ensure that research management independently makes all final decisions regarding the research coverage plan. However, Rule 2242(b)(2)(C) does not preclude personnel from these departments or any other department from conveying customer interests and coverage needs, so long as final decisions regarding the coverage plan are made by research management.

### Supervision and Control of Debt Research Analysts

Under Rule 2242(b)(2)(D), a member's written policies and procedures must limit the supervision and control of debt research analysts to persons not engaged in investment banking, sales and trading or principal trading activities. In addition, the policies and procedures further must establish information barriers or other institutional safeguards reasonably designed to ensure that debt research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking services, principal trading or sales and trading activities or others who might be biased in their judgment or supervision.<sup>5</sup>

### Budget and Compensation

Under Rule 2242(b)(2)(E), a member's written policies and procedures also must limit the determination of a firm's debt research department budget to senior management, excluding senior management engaged in investment banking or principal trading activities, and without regard to specific revenues or results derived from investment banking. However, the rule permits all persons to provide input to senior management regarding the demand for and quality of debt research, including product trends and customer interests and allows consideration by senior management of a firm's overall revenues and results in determining the debt research budget and allocation of expenses.

With respect to compensation determinations, a member's written policies and procedures must prohibit compensation based on specific investment banking services or trading transactions or contributions to a firm's investment banking or principal trading activities and prohibit investment banking and principal trading personnel from input into the compensation of debt research analysts.<sup>6</sup> Further, the firm's written policies and procedures must require that the compensation of a debt research analyst who is primarily responsible for the substance of a research report be reviewed and approved at least annually by a committee that reports to a member's board of directors or, if the member has no board of directors, a senior executive officer of the member.<sup>7</sup>

Neither investment banking personnel nor persons engaged in principal trading activities may give input with respect to the compensation determination for debt research analysts. However, sales and trading personnel may give input to debt research management as part of the evaluation process in order to convey customer feedback, provided that final compensation determinations are made by research management, subject to review and approval by the compensation committee.<sup>8</sup>

### **Retaliation**

Under Rule 2242(b)(2)(I), a member's written policies and procedures must prohibit direct or indirect retaliation or threat of retaliation against debt research analysts by any employee of the firm for publishing research or making a public appearance that may adversely affect the member's current or prospective business interests.

### **Personal Trading Restrictions**

Under Rule 2242(b)(2)(J), a member's written policies and procedures must restrict or limit trading by a "debt research analyst account" in securities, derivatives and funds whose performance is materially dependent upon the performance of securities covered by the debt research analyst.<sup>9</sup> The procedures must ensure that those accounts, supervisors of debt research analysts and associated persons with the ability to influence the content of debt research reports do not benefit in their trading from knowledge of the content or timing of debt research reports before the intended recipients of such research have had a reasonable opportunity to act on the information in the report. Furthermore, the procedures must prohibit a debt research analyst account from purchasing or selling any security or any option or derivative of such security in a manner inconsistent with the debt research analyst's most recently published recommendation, except that they may define circumstances of financial hardship in which the firm will permit trading contrary to that recommendation. In determining whether a particular trade is contrary to an existing recommendation, firms may take into account the context of a given trade, including the extent of coverage of the subject security.

FINRA will not consider a research analyst account to have traded in a manner inconsistent with a research analyst's recommendation where a member 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 universe, provided that the member establishes a reasonable plan to liquidate such holdings consistent with the principles in Rule 2242(b)(2)(J)(i) and such plan is approved by the member's legal or compliance department.<sup>10</sup>

### Promises of Favorable Research

Rule 2242(b)(2)(K) requires that the policies and procedures prohibit explicit or implicit promises of favorable debt research, specific research content or a specific rating or recommendation as inducement for the receipt of business or compensation.

### Solicitation and Marketing of Investment Banking Transactions

A member's written policies and procedures must restrict or limit activities by debt research analysts that can reasonably be expected to compromise their objectivity, including prohibiting participation in pitches and other solicitations of investment banking services transactions and road shows and other marketing on behalf of issuers related to such transactions.<sup>11</sup> As in the equity rule, Supplementary Material .01 interprets the solicitation provision to prohibit members from including in pitch materials any information about a member's research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable research.

Furthermore, Supplementary Material .01 provides that the solicitation provision prohibits members from including in pitch materials any information about a member's research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable research coverage.

### Joint Due Diligence With Investment Banking Personnel

The rule establishes a proscription with respect to joint due diligence activities (*i.e.*, due diligence by the debt research analyst in the presence of investment banking department personnel) prior to the selection of underwriters for the investment banking services transaction.<sup>12</sup> Supplementary Material .09 states that FINRA interprets the overarching principle requiring members 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 the performance of joint due diligence prior to the selection of underwriters for the investment banking services transaction.

Under Rule 2242(b)(2)(M), investment banking personnel are prohibited from directing debt research analysts to engage in sales or marketing efforts related to an investment banking services transaction or any communication with a current or prospective customer about an investment banking services transaction. Supplementary Material .02 clarifies that three-way meetings between debt research analysts and a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction are prohibited by this provision. Supplementary Material .02 also requires that any written or oral communication by a debt research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

### Communications Between Debt Research Analysts and Trading Personnel

Supplementary Material .03 delineates the prohibited and permissible interactions between debt research analysts and sales and trading and principal trading personnel. Members are required to establish, maintain and enforce written policies and procedures reasonably designed to prohibit sales and trading and principal trading personnel from attempting to influence a debt research analyst's opinions or views for the purpose of benefiting the trading position of the firm, a customer or a class of customers.

Debt research analysts are prohibited from identifying or recommending specific potential trading transactions to sales and trading or principal trading personnel that are inconsistent with such debt research analyst's currently published debt research reports or from disclosing the timing of, or material investment conclusions in, a pending debt research report.

Sales and trading and principal trading personnel may communicate customers' interests to a debt research analyst, so long as the debt research analyst does not respond by publishing debt research for the purpose of benefiting the trading position of the firm, a customer or a class of customers. In addition, debt research analysts may provide customized analysis, recommendations or trade ideas to sales and trading and principal trading personnel and customers, provided that any such communications are not inconsistent with the analyst's currently published or pending debt research, and that any subsequently published debt research is not for the purpose of benefiting the trading position of the firm, a customer or a class of customers.

Sales and trading and principal trading personnel are also permitted to seek the views of debt research analysts regarding the creditworthiness of the issuer of a debt security and other information regarding an issuer of a debt security that is reasonably related to the price or performance of the debt security, so long as, with respect to any covered issuer, such information is consistent with the debt research analyst's published debt research report and consistent in nature with the types of communications that a debt research analyst might have with customers. Finally, debt research analysts may seek information from sales and trading and principal trading personnel regarding a particular debt instrument, current prices, spreads, liquidity and similar market information relevant to the debt research analyst's valuation of a particular debt security.<sup>13</sup>

Unless otherwise prohibited, communications between debt research analysts and sales and trading or principal trading personnel that are not related to sales and trading, principal trading or debt research activities may take place without restriction.

In determining what is consistent with a debt research analyst's published research, a member may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the debt research analyst's published views.



### Restrictions on Communications With Customers and Internal Sales Personnel

A debt research analyst may not engage in any communication with a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction. Any written or oral communication by a debt research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.<sup>14</sup>

### Content and Disclosure in Debt Research Reports

The rule adopts the required disclosures in the equity research rule for debt research, with modifications to reflect the different characteristics of the debt market. Members are required to establish, maintain and enforce written policies and procedures reasonably designed to ensure that: (i) purported facts in their debt research reports are based on reliable information; and (ii) any recommendation or rating has a reasonable basis and is accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation or rating.<sup>15</sup> While there is no obligation to employ a rating system, members that choose to employ a rating system must clearly define in each debt research report the meaning of each rating in the system, including the time horizon and any benchmarks on which a rating is based. In addition, the definition of each rating must be consistent with its plain meaning.

Irrespective of the rating system a member employs, a member must include in each debt research report limited to the analysis of an issuer of a debt security (*i.e.*, a credit analysis) that includes a rating of the subject company, the percentage of all subject companies rated by the member to which the member would assign a “buy,” “hold” or “sell” rating. In addition, a member must disclose in each debt research report the percentage of subject companies within each of the “buy,” “hold” and “sell” categories for which the member has provided investment banking services within the previous 12 months. All such information must be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the publication date of the debt research report is less than 15 calendar days after the most recent calendar quarter.

If a debt research report limited to the analysis of an issuer of a debt security contains a rating for the subject company and the member has assigned a rating to such subject company for at least one year, the debt research report must show each date on which a member has assigned a rating to the debt security and the rating assigned on such date. This information is required for the period that the member has assigned any rating to the debt security or for a three-year period, whichever is shorter. Unlike the equity research rule, the debt research rule does not require those ratings to be plotted on a price chart because of limits on price transparency, including daily closing price information, with respect to many debt securities.

These provisions do not apply to debt research on individual debt securities, only to an analysis of the issuer of a debt security.

A member is required to disclose in any debt research report at the time of publication or distribution of the report:

- ▶ if the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, any option, right, warrant, future, long or short position), and the nature of such interest;
- ▶ if the debt research analyst has received compensation based upon (among other factors) the member's investment banking, sales and trading or principal trading revenues;
- ▶ if the member or any of its affiliates managed or co-managed a public offering of securities for the subject company in the past 12 months; received compensation for investment banking services from the subject company in the past 12 months; or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;
- ▶ if, as of the end of the month immediately preceding the date of publication or distribution of a debt research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month), the member or its affiliates have received from the subject company any compensation for products or services other than investment banking services in the previous 12 months;
- ▶ if the subject company is, or over the 12-month period preceding the date of publication or distribution of the debt research report has been, a client of the member, and if so, the types of services provided to the issuer. Such services, if applicable, shall be identified as either investment banking services, non-investment banking securities-related services or non-securities services;
- ▶ if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report;
- ▶ if the debt research analyst received any compensation from the subject company in the previous 12 months; and
- ▶ any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of the publication or distribution of a debt research report.<sup>16</sup>

Disclosure of firm ownership of debt securities is required in research reports or a public appearance to the extent those holdings constitute a material conflict of interest.<sup>17</sup> Further, Rule 2242(c)(5) provides an exception for disclosure that would reveal material non-public information regarding specific potential future investment banking transactions.

Disclosures must be presented on the front page of debt research reports or the front page must refer to the page on which the disclosures are found. Electronic debt research reports must provide a hyperlink directly to the required disclosures. All disclosures and references to disclosures required by the rule must be clear, comprehensive and prominent.<sup>18</sup>

### **Disclosure of Compensation Received by Affiliates**

The rule permits a member to satisfy the disclosure requirement with respect to receipt of non-investment banking services compensation by an affiliate by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the affiliate as to whether the affiliate received such compensation.<sup>19</sup> In addition, the rule permits a member to satisfy the disclosure requirement with respect to the receipt of investment banking compensation from a foreign sovereign by a non-U.S. affiliate of the member by implementing written policies and procedures reasonably designed to prevent the debt research analyst and associated persons of the member with the ability to influence the content of debt research reports from directly or indirectly receiving information from the non-U.S. affiliate as to whether such non-U.S. affiliate received or expects to receive such compensation from the foreign sovereign. However, a member must disclose receipt of compensation by its affiliates from the subject company (including any foreign sovereign) in the past 12 months when the debt research analyst or an associated person with the ability to influence the content of a debt research report has actual knowledge that an affiliate received such compensation during that time period.

### **Disclosure in Public Appearances**

Rule 2242(d)(1) requires a debt research analyst to disclose in public appearances:

- ▶ if the debt research analyst or a member of the debt research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), and the nature of such interest;
- ▶ if, to the extent the debt research analyst knows or has reason to know, the member or any affiliate received any compensation from the subject company in the previous 12 months;

- ▶ if the debt research analyst received any compensation from the subject company in the previous 12 months;
- ▶ if, to the extent the debt research analyst knows or has reason to know, the subject company currently is, or during the 12-month period preceding the date of publication or distribution of the debt research report, was, a client of the member. In such cases, the debt research analyst also must disclose the types of services provided to the subject company, if known by the debt research analyst; or
- ▶ any other material conflict of interest of the debt research analyst or member that the debt research analyst knows or has reason to know at the time of the public appearance.<sup>20</sup>

Rule 2242(d)(3) requires members to maintain records of public appearances by debt research analysts sufficient to demonstrate compliance by those debt research analysts with the applicable disclosure requirements for public appearances. Such records must be maintained for at least three years from the date of the public appearance.

#### **Disclosure Required by Other Provisions**

With respect to both research reports and public appearances, Rule 2242(e) requires that, in addition to the disclosures required under the rule, members and debt research analysts must comply with all applicable disclosure provisions of FINRA Rule 2210 (Communications with the Public) and the federal securities laws.

#### **Distribution of Member Research Reports**

Rule 2242(f) requires firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that a debt research report is not distributed selectively to internal trading personnel or a particular customer or class of customers in advance of other customers that the member has previously determined are entitled to receive the debt research report.

Firms may provide different debt research products and services to different classes of customers, provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm discloses its research dissemination practices to all customers that receive a research product. A member that provides different debt research products and services for certain customers must inform its other customers that its alternative debt research products and services may reach different conclusions or recommendations that could impact the price of the debt security.<sup>21</sup> The notification need not be included in every research report; however, a customer must be notified of the alternative research products, services and dissemination practices prior to receiving or accessing a research report for the first time and promptly after any material changes to a firm's research products, services or dissemination practices.

### Distribution of Third-party Debt Research Reports

Rule 2242(g)(1) prohibits a member from distributing third-party debt research if it knows or has reason to know that such research is not objective or reliable. A member satisfies the standard based on its actual knowledge and reasonable diligence; however, there is no duty of inquiry to definitively establish that the third-party research is, in fact, objective and reliable.

In addition, Rule 2242(g)(2) requires a member to establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party debt research report it distributes contains no untrue statement of material fact and is otherwise not false or misleading. For the purpose of this requirement, a member's obligation to review a third-party debt research report extends to any untrue statement of material fact or any false or misleading information that should be known from reading the debt research report or is known based on information otherwise possessed by the member.

Rule 2242(g)(3) requires a member to accompany any third-party debt research report it distributes with, or provide a Web address that directs a recipient to, disclosure of any material conflict of interest that can reasonably be expected to have influenced the choice of a third-party debt research report provider or the subject company of a third-party debt research report, including:

- ▶ if the member or any of its affiliates managed or co-managed a public offering of securities for the subject company in the past 12 months; received compensation for investment banking services from the subject company in the past 12 months; or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months;
- ▶ if the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report; and
- ▶ any other material conflict of interest of the debt research analyst or member that the debt research analyst or an associated person of the member with the ability to influence the content of a debt research report knows or has reason to know at the time of the publication or distribution of a debt research report.

Rule 2242(g)(4) provides that members are not required to review a third-party debt research report prior to distribution if such debt research report is an independent third-party debt research report. For the purposes of the disclosure requirements for third-party research reports, a member shall not be considered to have distributed a third-party debt research report where the research is an independent third-party debt research report and made available by a member upon request, through a member-maintained website, or 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 debt research on the solicited debt security and the customer requests such independent debt research.<sup>22</sup>

Under Rule 2242(g)(6) members must ensure that third-party debt research reports are clearly labeled as such and that there is no confusion on the part of the recipient as to the person or entity that prepared the debt research reports. Absent such clarity, the research report will be treated as the member's own research report.

### **Obligations of Persons Associated With a Member**

Consistent with FINRA Rule 0140, persons associated with a member must comply with such member's written policies and procedures as established pursuant to the rule. In addition, consistent with Rule 0140, Supplementary Material .08 provides that it shall be a violation of Rule 2422 for an associated person to engage in the restricted or prohibited conduct to be addressed through the establishment, maintenance and enforcement of written policies and procedures required by provisions of the rule, including applicable Supplementary Material.

### **Exemption for Members With Limited Investment Banking Activity**

Rule 2242(h) exempts from certain provisions regarding supervision and compensation of debt research analysts those members that over the previous three years, on average per year, have participated in 10 or fewer investment banking services transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions.<sup>23</sup> However, members with limited investment banking activity must establish information barriers or other institutional safeguards reasonably designed to ensure debt research analysts are insulated from pressure by persons engaged in investment banking services activities or other persons, including persons engaged in principal trading or principal sales and trading activities, who might be biased in their judgment or supervision.

The rule still prohibits these firms from compensating a debt research analyst based upon specific investment banking services transactions or contributions to a member's investment banking services activities. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to all of the requirements of Rule 2242(b).

### **Exemption for Limited Principal Trading Activity**

Rule 2242(i) includes an exemption from certain provisions regarding supervision and compensation of debt research analysts for members that engage in limited principal trading activity where: (1) in absolute value on an annual basis, the member's trading gains or losses on principal trades in debt securities are \$15 million or less over the previous three years, on average per year; and (2) the member employs fewer than 10 debt traders; provided, however, such members must establish information barriers or other institutional safeguards reasonably designed to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision.<sup>24</sup>

As with the limited investment banking activity exemption, members are still required to establish information barriers or other institutional safeguards reasonably designed to ensure debt research analysts are insulated from pressure by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision. Members that qualify for this exemption must maintain records sufficient to establish eligibility for the exemption and also maintain for at least three years any communication that, but for this exemption, would be subject to all of the requirements of Rule 2242(b).

### Exemption for Debt Research Reports Provided to Institutional Investors

Rule 2242(j) exempts debt research distributed solely to eligible institutional investors (institutional debt research) from most of the provisions regarding supervision, coverage determinations, budget and compensation determinations and all of the disclosure requirements applicable to debt research reports distributed to retail investors (“retail debt research”).<sup>25</sup>

Rule 2242(j) requires either negative or affirmative written consent for eligible institutional investors to receive the less protected institutional debt research. Specifically, Rule 2242(j) allows firms to distribute institutional debt research by negative consent to a person who meets the definition of a qualified institutional buyer (QIB) and where, pursuant to FINRA Rule 2111(b): (1) the member or associated person has a reasonable basis to believe that the QIB is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a debt security or debt securities; and (2) the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the member’s recommendations pursuant to Rule 2111 and such affirmation is broad enough to encompass transactions in debt securities. The rule requires written disclosure to the QIB that the member may provide debt research reports that are intended for institutional investors and are not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors. If the QIB does not contact the member and request to receive only retail debt research reports, the member may reasonably conclude that the QIB has consented to receiving institutional debt research reports.<sup>26</sup> FINRA interprets this standard to allow an order placer, *e.g.*, an investment adviser, for a QIB that satisfies the Rule 2111 suitability requirements with respect to debt transactions to agree to receive institutional debt research on behalf of the QIB by negative consent.

Institutional accounts that meet the definition of FINRA Rule 4512(c) but do not satisfy the higher tier requirements described above may still affirmatively elect in writing to receive institutional debt research. Specifically, a person that meets the definition of “institutional account” in Rule 4512(c) may receive institutional debt research provided that such person, prior to receipt of a debt research report, has affirmatively notified the member in writing that it wishes to receive institutional debt research and forego treatment as a retail investor for the purposes of the rule. Retail investors may not choose to receive institutional debt research.<sup>27</sup>

To avoid a disruption in the receipt of institutional debt research, the rule allows firms to send institutional debt research to any Rule 4512(c) account, except a natural person, without affirmative or negative consent for a period of up to one year after SEC approval while they obtain the necessary consents. Natural persons that qualify as an institutional account under Rule 4512(c) must provide affirmative consent to receive institutional debt research during this transition period and thereafter.<sup>28</sup>

The exemption relieves members that distribute institutional debt research to institutional investors from the requirements to have written policies and procedures for this research with respect to:

1. restricting or prohibiting prepublication review of institutional debt research by principal trading and sales and trading personnel or others outside the research department, other than investment banking personnel;
2. input by investment banking, principal trading and sales and trading into coverage decisions;
3. limiting supervision of debt research analysts to persons not engaged in investment banking, principal trading or sales and trading activities;
4. limiting determination of the debt research department's budget to senior management not engaged in investment banking or principal trading activities and without regard to specific revenues derived from investment banking;
5. determination of debt research analyst compensation;
6. restricting or limiting debt research analyst account trading; and
7. information barriers or other institutional safeguards reasonably designed to ensure debt research analysts are insulated from review or oversight by investment banking, sales and trading or principal trading personnel, among others (but members still must have written policies and procedures to guard against those persons pressuring analysts).

The exemption further applies to all disclosure requirements, including content and disclosure requirements for third-party research.

Notwithstanding the exemption, some provisions of the rule still apply to institutional debt research, including the prohibition on prepublication review of debt research reports by investment banking personnel and the restrictions on such review by subject companies. While prepublication review by principal trading and sales and trading personnel is permitted pursuant to the exemption, other provisions of the rule continue to require management of those conflicts, including the requirement to establish information barriers reasonably designed to insulate debt research analysts from pressure by those persons. Furthermore, the requirements in Supplementary Material .05 related to submission of sections of a draft debt research report for factual review applies to any permitted prepublication review by persons not directly responsible for the preparation, content or



distribution of debt research reports. In addition, members must prohibit debt research analysts from participating in the solicitation of investment banking services transactions, road shows and other marketing on behalf of issuers and further prohibit investment banking personnel from directly or indirectly directing a debt research analyst to engage in sales and marketing efforts related to an investment banking deal or to communicate with a current or prospective customer with respect to such transactions. The provisions regarding retaliation against debt research analysts and promises of favorable debt research also still apply with respect to research distributed to eligible institutional investors.<sup>29</sup>

While the rule does not require institutional debt research to carry the specific disclosures applicable to retail debt research, it does require that such research carry general disclosures prominently on the first page warning that:

1. the report is intended only for institutional investors and does not carry all of the independence and disclosure standards of retail debt research reports;
2. if applicable, that the views in the report may differ from the views offered in retail debt research reports; and
3. if applicable, that the report may not be independent of the firm's proprietary interests and that the firm trades the securities covered in the report for its own account and on a discretionary basis on behalf of certain customers, and such trading interests may be contrary to the recommendation in the report.<sup>30</sup>

Rule 2242(j)(4) requires members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that institutional debt research is made available only to eligible institutional investors. A member may not rely on the exemption with respect to a debt research report that the member has reason to believe will be redistributed to a retail investor. However, absent a red flag, this provision does not create a duty to inquire or conduct due diligence to determine whether institutional debt research will be redistributed to a retail investor. The exemption does not relieve a member of its obligations to comply with the antifraud provisions of the federal securities laws and FINRA rules.

### **General Exemptive Authority**

Rule 2242(k) provides FINRA, pursuant to the FINRA Rule 9600 Series, with authority to conditionally or unconditionally grant, in exceptional and unusual circumstances, an exemption from any requirement of the rule for good cause shown, after taking into account all relevant factors and provided that such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.

### **Implementation Date**

The rule will become effective on February 22, 2016.

## Endnotes

1. See Securities Exchange Act Rel. No. 75472 (July 16, 2015), 80 FR 43528 (July 22, 2015) (Order Approving File No. SR-FINRA-2014-048).
2. The SEC separately approved FINRA's proposal to amend and adopt NASD Rule 2711 (Research Analysts and Research Reports) as consolidated FINRA Rule 2241. See Securities Exchange Act Rel. No. 75471 (July 16, 2015), 80 FR 43482 (July 22, 2015) (Order Approving File No. SR-FINRA-2014-047) (the "equity research rule"). See also [Regulatory Notice 15-30](#). That proposal also amended NASD Rule 1050 (Registration of Research Analysts) and Incorporated NYSE Rule 344 (Research Analysts and Supervisory Analysts) to create a limited exemption from the research analyst registration and qualification requirements. Those requirements only apply to equity research analysts. FINRA is considering whether debt research analysts also should be subject to the same or a similar qualification requirement.
3. The rule defines "sales and trading personnel" to include persons in any department or division, whether or not identified as such, who perform any sales and trading service on behalf of a member. FINRA intends for the term "sales and trading" to exclude principal and proprietary trading activities. See Rule 2242(a)(15).
4. See Rule 2242.05 (Submission of Sections of a Draft Research Report for Factual Review).
5. See Rule 2242(b)(2)(H).
6. See Rule 2242(b)(2)(D) and (F).
7. See Rule 2242(b)(2)(G). This committee may not have representation from investment banking personnel or persons engaged in principal trading activities and must consider the following factors when reviewing a debt research analyst's compensation, if applicable: the debt research analyst's individual performance, including the analyst's productivity and the quality of the debt research analyst's research; and the overall ratings received from customers and peers (independent of the member's investment banking department and persons engaged in principal trading activities) and other independent ratings services.
8. See Rule 2242(b)(2)(D) and (G). The committee, which may not have representation from investment banking or persons engaged in principal trading activities, must document the basis for each debt research analyst's compensation, including any input from sales and trading personnel.
9. Rule 2242(a)(2) defines "debt research analyst account" to mean any account in which a debt research analyst or member of the debt research analyst's household has a financial interest, or over which such analyst has discretion or control; provided, however, it does not include an investment company registered under the Investment Company Act of 1940 over which the debt research analyst or a member of the debt research analyst's household has discretion or control, provided that the debt research analyst or member of a debt research analyst's household has no financial interest in such investment company, other than a performance or management fee. The term also does not include a "blind trust" account that is controlled by a person other than the debt research analyst or member of the debt research analyst's household where neither the debt research analyst nor a member of the debt research analyst's household knows of the account's investments or investment transactions.
10. See Rule 2242.10.
11. See Rule 2242(b)(2)(L).

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12. See Rule 2242(b)(1)(C) and Rule 2242.09 (Joint Due Diligence).
13. See Rule 2242.03 (Information Barriers between Research Analysts and Trading Desk Personnel).
14. See Rule 2242.02(b) (Restrictions on Communications with Customers and Internal Personnel).
15. See Rule 2242(c)(1)(A), (c)(1)(B), and (c)(2).
16. See Rule 2242(c)(4). The “catch all” disclosure requires disclosure of material conflicts known not only by the research analyst, but also by any “associated person of the member with the ability to influence the content of a research report.” A person with the “ability to influence the content of a research report” is an associated person who is required to review the content of the debt research report or has exercised authority to review or change the debt research report prior to publication or distribution. This term does not include legal or compliance personnel who may review a debt research report for compliance purposes but are not authorized to dictate a particular recommendation or rating. See Rule 2242.07 (Ability to Influence the Content of a Debt Research Report). The “reason to know” standard in the provision covers disclosure of those conflicts that should reasonably be discovered by those persons in the ordinary course of discharging their functions.
17. See Rules 2242(c)(4)(H) and (d)(1)(E).
18. See Rule 2242(c)(6). A member that distributes a debt research report covering six or more companies (compendium report) may direct the reader in a clear manner to the applicable disclosures. Electronic compendium reports must include a hyperlink to the required disclosures. Paper-based compendium reports must provide either a toll-free number or a postal address to request the required disclosures and also may include a Web address of the member where the disclosures can be found. See Rule 2242(c)(7).
19. See Rule 2242.04 (Disclosure of Compensation Received by Affiliates).
20. A member or debt research analyst is not required to make any such disclosure to the extent it reveals material non-public information regarding specific potential future investment banking transactions. The “catch-all” disclosure requirement in public appearances applies only to a conflict of interest of the debt research analyst or member that the analyst knows or has reason to know at the time of the public appearance.
21. See Rule 2242.06 (Distribution of Member Research Products).
22. See Rule 2242(g)(5).
23. Specifically, members that meet those thresholds are exempt from the requirement to establish, maintain and enforce policies and procedures that: prohibit prepublication review of debt research reports by investment banking personnel or other persons not directly responsible for the preparation, content or distribution of debt research reports (but not principal trading or sales and trading personnel, unless the member also qualifies for the limited principal trading activity exemption); restrict or limit investment banking personnel from input into coverage decisions; limit supervision of debt research analysts to persons not engaged in investment banking; limit determination of the research department budget to senior management, excluding senior management engaged in investment banking activities; require that compensation of a debt research analyst be approved by a compensation committee that

- may not have representation from investment banking personnel; and establish information barriers to insulate debt research analysts from the review or oversight by persons engaged in investment banking services or other persons who might be biased in their judgment or supervision.
24. Specifically, members that meet those thresholds are exempt from the requirement to establish, maintain and enforce policies and procedures that: prohibit prepublication review of debt research reports by principal trading or sales and trading personnel or other persons not directly responsible for the preparation, content or distribution of debt research reports (but not investment banking personnel, unless the firm also qualifies for the limited investment banking activity exemption); restrict or limit principal trading or sales and trading personnel from input into coverage decisions; limit supervision of debt research analysts to persons not engaged in sales and trading or principal trading activities, including input into the compensation of debt research analysts; limit determination of the research department budget to senior management, excluding senior management engaged in principal trading activities; require that compensation of a debt research analyst be approved by a compensation committee that may not have representation from principal trading personnel; and establish information barriers to insulate debt research analysts from the review or oversight by persons engaged in principal trading or sales and trading activities or other persons who might be biased in their judgment or supervision.
25. A “retail investor” includes any person other than an institutional investor. *See* Rule 2242(a)(13).
26. *See* Rule 2242(j)(1)(A)(i) and (ii).
27. *See* Rule 2242(j)(1)(B).
28. *See* Rule 2242.11 (Distribution of Institutional Debt Research During Transition Period).
29. *See* Rule 2242(j)(2).
30. *See* Rule 2242(j)(3).