

Desk Commentary Safe Harbor

FINRA Requests Comment on Proposed Limited Safe Harbor From FINRA Equity and Debt Research Rules for Desk Commentary

Comment Period Expires: May 30, 2017

Executive Summary

FINRA seeks comment on proposed amendments to FINRA Rule 2241 (Research Analysts and Research Reports) and FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) to create a limited safe harbor for specified brief, written analysis distributed to eligible institutional investors that comes from sales and trading or principal trading personnel but that may rise to the level of a research report (desk commentary). The proposed safe harbor would be subject to conditions, including compliance with a number of the Rule 2241 or Rule 2242 provisions to mitigate research-related conflicts. In addition, the proposed safe harbor would require firms to include a “health warning” on desk commentary and to obtain negative consent from eligible institutional investors to receive such commentary.

In a separate *Regulatory Notice*, FINRA is also requesting comment generally on its rules and programs governing the capital raising process and their effects on capital formation. In response to that *Notice* or this one, commenters are welcome to suggest changes to Rules 2241 and 2242 beyond those proposed below.¹

Questions regarding this *Notice* should be directed to:

- ▶ Philip Shaikun, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8451 or Philip.Shaikun@finra.org; or
- ▶ Jeanette Wingler, Associate General Counsel, OGC, at (202) 728-8013 or Jeanette.Wingler@finra.org.

April 2017

Notice Type

- ▶ Request for Comment

Suggested Routing

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

Key Topics

- ▶ Conflicts of Interest
- ▶ Investment Banking
- ▶ Research
- ▶ Trading

Referenced Rules

- ▶ FINRA Rule 2111
- ▶ FINRA Rule 2210
- ▶ FINRA Rule 2241
- ▶ FINRA Rule 2242
- ▶ FINRA Rule 4512(c)
- ▶ NASD Rule 1050

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by May 30, 2017.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.²

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).³

Background & Discussion

Many firms produce desk commentary, a type of sales material directed to institutional investors that is based on the observations of sales and trading or principal trading personnel. These communications are usually brief, focused on the near term, and prepared and disseminated quickly in response to trading events or news flashes.

FINRA understands that many institutional investors value the timely flow of information and trade ideas from desk personnel but do not base their investment decisions on the commentary. Instead, these investors, which are capable of exercising independent judgment in evaluating recommendations and reaching investment decisions, selectively incorporate the information as a data point into their own analysis and trading process. FINRA further understands that oftentimes, the desk commentary never reaches the portfolio manager or others who make the investment decisions. Rather, it may inform buy-side traders' timing in executing orders to carry out previously made investment decisions. Importantly, the recipients of desk commentary understand the types of potential conflicts that may exist between the trading ideas and recommendations generated by desk personnel and a member's trading interests.

Depending on the content, desk commentary can sometimes constitute a “research report” or “debt research report” under Rules 2241 and 2242, FINRA’s equity and debt research conflict of interest rules. In general, those terms are defined in the respective rules to cover any written (including electronic) communication that includes an analysis of “equity securities of individual companies or industries” (Rule 2241) or “debt security or an issuer of a debt security” (Rule 2242) and that provides information reasonably sufficient upon which to base an investment decision.⁴

In some instances, FINRA has seen what effectively amounts to fundamental research coming off the trading desk. In those circumstances, there is no question that the communications meet the definition of a research report and should be subject to rigorous supervisory review to ensure compliance with all of the applicable provisions of either Rule 2241 or 2242.⁵ As discussed below, this type of research would not qualify as desk commentary eligible for the safe harbor.

More commonly, FINRA has observed that desk commentary does not meet the definition of a research report due to either insufficient analysis or because the communication falls into a specified exception to the definition. However, in some cases, desk commentary may technically fall within the research report definition, even where it falls well short of the type of fundamental research that originally gave rise to the research conflict of interest rules. FINRA understands that discerning between those desk communications that fall just on either side of the line of being a research report can sometimes be difficult and that the supervisory scrutiny required to make those judgments can impede the timely receipt of the information by those institutional investors that value it.

As such, the proposed safe harbor for desk commentary is intended to create a feasible and effective supervisory framework that will provide firms more compliance certainty in their review of these research communications, subject to a number of conditions, including compliance with key conflict management provisions of the rules. The proposal seeks to maintain the information flow from the desk that is valued by institutional investors, while continuing to provide safeguards commensurate with the context and scope of the communications and the experience and sophistication of its recipients. Significantly, the proposal would maintain the full protections of the research rules for any research distributed to retail investors. And firms must still establish, maintain and enforce written procedures reasonably designed to prevent the dissemination of material non-public research information.

Safe Harbor Conditions

The proposal would provide a non-exclusive safe harbor from some—but not all—of the research rule provisions for eligible desk commentary, subject to several conditions. The safe harbor would be available to desk commentary that meets the author, content and recipient conditions set out below. If the conditions are satisfied, the communication

and its author would be exempt from all of the provisions of either Rule 2241 or 2242, as applicable, except for those provisions with which compliance is specified as a condition for the safe harbor. Desk commentary that meets the definition of research report but falls outside of these conditions—*e.g.*, fundamental research or research distributed to retail investors—would be subject to the full scope of the applicable research rules.

FINRA notes that the content limitation is not intended to define such communications as research reports for the purposes of the safe harbor or other contexts. In providing a non-exclusive safe harbor, FINRA would not preclude firms from making their own considered determination that desk commentary does not constitute a research report and therefore is not subject to the rules. However, a firm that produces desk commentary that rises to the level of a research report but fails to satisfy the conditions of the proposed safe harbor could be found to have violated the research rules.

Author, Content and Recipient

As a threshold matter, the proposed safe harbor would be available only for communications that meet the following conditions, which would be set forth in the rule text:

1. **Author:** “must be produced by sales and trading and principal trading personnel who: (a) are not primarily engaged in the preparation of research reports that do not meet the safe harbor content limitation; (b) do not require registration as a research analyst pursuant to NASD Rule 1050 (Registration of Research Analysts) because their primary job function is something other than to provide investment research; and (c) do not report directly or indirectly to research department personnel”;
2. **Content:** “limited to brief observations (not including a rating, price target or earnings estimate)⁶ regarding recent, current, or near term expected trading activity, trading ideas or opportunities, market conditions, economic statistics or company results, or regarding a recent recommendation or research report”; and
3. **Recipient:** “may only be distributed solely to consenting investors that meet the definition of “institutional account” under FINRA Rule 4512(c) (Customer Account Information) and have satisfied the FINRA Rule 2111 (Suitability) institutional suitability standard with respect to equity or debt transactions or trading strategies, as applicable.”

The recipient condition of the safe harbor would limit distribution of desk commentary to investors that satisfy the Rule 2111 institutional suitability standard and from which the firm has received negative consent to receive the communications. More specifically, recipients must be limited to investors that meet the definition of an “institutional account” in Rule 4512(c) (including natural persons), where, pursuant to Rule 2111(b): (1) the firm or associated person has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving equity or debt

securities, as applicable; and (2) the institutional investor has affirmatively indicated that it is exercising independent judgment in evaluating the firm's recommendations pursuant to Rule 2111.

The necessary consent may be obtained by written disclosure to the institutional investor that the firm may provide the investor desk commentary from sales and trading or principal trading personnel that may sometimes constitute research reports under FINRA rules that is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to research reports prepared for retail investors. If the institutional investor does not contact the firm and request to receive only research reports subject to the full protections of Rules 2241 or 2242, as applicable, the firm may reasonably conclude that the institutional investor has consented to receiving communications for the purpose of the safe harbor.

To avoid a disruption in the receipt of desk commentary, the proposal would provide firms a transition period during which desk commentary eligible for the safe harbor could be sent to eligible institutional investors while firms obtain the necessary consents. Specifically, the proposal would allow a firm to send desk research to any account that meets the definition of an "institutional account" in Rule 4512(c) without negative consent for a period of up to 90 days after the effective dates of the proposed amendments.

FINRA believes that allowing negative consent and the transition period would reduce operational and cost burdens for firms while preserving institutional investors' ability to opt-out of receiving less-protected desk commentary. Institutional investors would retain the option to receive only research reports that are subject to the full protections of Rules 2241 and 2242. Significantly, the proposal would not diminish protection for retail investors, who would retain the full protections of the research rules, irrespective of the author or department of origin. Moreover, FINRA believes that the author, content and recipient threshold conditions would effectively preclude firms from migrating the research function to the desk to avoid the requirements of Rule 2241 or Rule 2242.

Conflict Management

The proposed safe harbor under both Rules 2241 and 2242 would require compliance with several common provisions of those rules to mitigate the most serious research-related conflicts that can be present with desk commentary.⁷ In describing the existing provisions that must be complied with as conditions of the safe harbor, FINRA maintains the use of the term "research report" to mean the desk commentary that is eligible for the safe harbor and "research analyst" to mean the sales and trading or principal trading personnel who author such desk commentary. As set forth in more detail below, the proposed safe harbor for equity desk commentary would require compliance with additional provisions of Rule 2241 to mitigate the influences of investment banking.⁸

The proposed safe harbor under both Rules 2241 and 2242 would require a firm to establish, maintain and enforce written policies and procedures reasonably designed to:

- ▶ prevent the use of research reports or research analysts to manipulate the market and prohibit prepublication review, clearance or approval of research reports by persons engaged in investment banking services activities;
- ▶ establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from pressure by persons engaged in investment banking services activities or other persons, including sales and trading personnel, who might be biased in their judgment or supervision;⁹
- ▶ prohibit direct or indirect retaliation or threats of retaliation against research analysts by persons engaged in investment banking services activities or other employees as the result of an adverse, negative, or otherwise unfavorable research report written by the research analyst that may adversely affect the firm's present or prospective business interests;
- ▶ prohibit explicit or implicit promises of favorable research, a particular research rating or recommendation or specific research content as inducement for the receipt of business or compensation;
- ▶ restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, including prohibiting: (1) participation in pitches and other solicitations of investment banking services transactions; and (2) participation in road shows¹⁰ and other marketing on behalf of an issuer related to an investment banking services transaction;¹¹
- ▶ prohibit investment banking department personnel from directly or indirectly: (1) directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction; and (2) directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction;
- ▶ prohibit prepublication review of a research report by a subject company;¹² and
- ▶ prohibit research analysts from engaging 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.

The safe harbor further would require firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that desk commentary subject to the safe harbor is made available only to eligible institutional investors. A firm could not rely on the proposed safe harbor with respect to such desk commentary that the firm has reason to believe will be redistributed to a retail investor. In addition, the proposed safe harbor would not relieve a firm of its obligations to comply with the anti-fraud provisions of the federal securities laws and FINRA rules.

Importantly, the safe harbor would in no way impact a firm's obligation to establish, maintain and enforce written procedures reasonably designed to prevent the dissemination of material non-public research information (*e.g.*, selective early disclosure of ratings, price targets and earnings estimates). Accordingly, firms would continue to be required to have written policies and procedures in place to prevent distributing desk commentary that incorporates internal material non-public information from the research department, such as changes in a research analyst's views on a company to be included in a subsequent research report. As a practical matter, desk commentary that includes material non-public research information inherently would not satisfy the content limitation to be considered eligible for the proposed safe harbor.

Disclosure

The proposed safe harbor would require desk commentary to carry a "health warning" similar to what is required for debt research distributed pursuant to the institutional debt research exemption in Rule 2242(j). The health warning would state:

- ▶ "This document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to research reports prepared for retail investors"; and
- ▶ If applicable, "Clients should assume that this document is not independent of [Firm's] proprietary interests. [Firm] trades, and will continue to trade, the securities covered in this document for its own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to or entered into in advance of this document."¹³

FINRA believes this general health warning in lieu of the specific conflict disclosures in the rules is appropriate for desk commentary's targeted audience of institutional investors that have indicated they are capable of evaluating risks and are exercising independent judgment with respect to recommendations. Moreover, FINRA believes that disclosure of specific conflicts with respect to desk commentary subject to the safe harbor would provide minimal value to those investors relative to the cost to track the conflicts and the likely negative impact on the timeliness of the analysis and trade ideas they wish to receive.

Additional Requirements for Equity Desk Commentary Safe Harbor

The safe harbor for equity desk commentary would require compliance with additional provisions of Rule 2241 to mitigate against the influences of investment banking. Specifically, a firm would also be required to have policies and procedures reasonably designed to:

- ▶ prohibit persons engaged in investment banking activities from supervision or control of research analysts, including influence or control over research analyst compensation evaluation and determination;

- ▶ limit determination of the research department budget to senior management, excluding senior management engaged in investment banking services activities; and
- ▶ prohibit compensation based upon specific investment banking services transactions or contributions to a firm's investment banking services activities.¹⁴

FINRA believes these additional requirements on the equity side are justified by the history of improper influence by investment banking over equity research and the increased likelihood that equity research may affect stock prices.¹⁵

Safe Harbor Relief

Compliance with the aforementioned safe harbor conditions would relieve a firm that produces and distributes desk commentary from compliance with several of the rules' conflicts management provisions—including, notably the separation requirements between research and sales and trading and principal trading personnel—and the specific disclosure requirements.

The safe harbor also would exclude compliance with the registration and qualification requirements for equity research analysts. NASD Rule 1050, including its qualification requirements, applies to a research analyst who is primarily responsible for the preparation of the substance of an equity research report or whose name appears on an equity research report. The registration and qualification requirements were intended to ensure, among other things, that those individuals whose primary job function is to produce research have demonstrated a minimum level of competency in the analysis and valuation of securities. This requirement is particularly important where the research report is distributed to retail investors who may rely on the research to make an investment decision. Because desk commentary subject to the safe harbor may not be distributed to retail investors, it does not present the same retail investor protection issues as research subject to the NASD Rule 1050 requirement.

Given the limitations on desk commentary that may rise to the level of a research report, the proposed safe harbor would not require that desk commentary authors register pursuant to NASD Rule 1050. And since desk commentary authors would not be subject to the registration requirements, the proposal also would exempt associated persons who review equity desk commentary from the requirement to register as a Research Principal. Notably, this relief would not be available to an associated person whose job function would otherwise require registration as a research analyst pursuant to NASD Rule 1050 (*e.g.*, due to producing communications that are research reports but do not meet the author, content and recipient limitations of the proposed desk commentary safe harbor).

Differences Between Proposed Debt Desk Commentary Safe Harbor and the Institutional Debt Research Exemption

While the proposed desk commentary safe harbor is similar to the institutional debt research exemption in Rule 2242(j), there are some notable differences. Under the proposal, the institutional debt exemption would be retained and a separate debt desk research safe harbor would be added. A significant difference between the institutional debt exemption and the proposed debt desk commentary safe harbor is that the institutional debt research exemption applies more broadly to all debt research reports, not just debt research coming from sales and trading and principal personnel. In addition, the desk commentary safe harbor would carry a slightly different health warning.

While the institutional debt exemption currently provides relief from the same provisions that would be captured by the proposed debt desk commentary safe harbor, the required consents for the former are more onerous. Specifically, the institutional debt exemption distinguishes between institutions in the manner in which the consent is obtained. In general, larger institutions are permitted to receive institutional debt research based on negative consent, while smaller institutions are required to affirmatively consent to receive that research. Given the limited scope of desk commentary eligible for the safe harbor and to preserve the information flow to both larger and smaller institutional investors, the proposed safe harbor would not distinguish between larger and smaller institutional investors.

Rather, the proposed debt desk commentary safe harbor would require only negative consent by a Rule 4512(c) institutional account that also satisfies the Rule 2111 institutional suitability standards to receive debt desk commentary, which is consistent with the approach taken in the proposed safe harbor for equity desk commentary. Thus, it would be easier for firms to avail themselves of the debt commentary safe harbor if the conditions are met, but that safe harbor would be limited to a narrower set of communications. Like the institutional debt research exemption, the proposed debt desk commentary safe harbor would not permit retail investors to consent to receive that commentary that may rise to the level of a research report.

Economic Impact Assessment

The proposal would directly impact firms that regularly produce and distribute desk commentary. The exemption of desk commentary from many of the Rule 2241 and Rule 2242 provisions should provide firms with the flexibility to provide timely analysis that institutional investors would value. While the proposed safe harbor is non-exclusive, it may increase compliance costs for firms that may need to modify their current written policies and procedures or for some firms, establish new policies and procedures reasonably designed to ensure that the desk commentary subject to the safe harbor contains only brief, short-term observations about trading activity, trading opportunities, market conditions,

economic statistics or company results, or regarding another recent recommendation or research; and is distributed only to institutional investors that have consented to receive the desk commentary.

FINRA also considered the potential impacts of the proposed amendments on investors. Retail investors are not expected to be impacted by the proposed exemption, as, FINRA understands, they do not receive desk commentary in the current regulatory environment and firms may distribute desk commentary only to institutional investors pursuant to the safe harbor. FINRA believes that sophisticated institutional investors do not rely on desk commentary as the sole basis for decision making and are aware of the potential conflicts presented by those communications produced by sales and trading and principal trading departments.

In addition, the proposed safe harbor in Rules 2241 and 2242 would be similar, but not congruent, to the exemption for debt research reports distributed to eligible institutional investors in Rule 2242. As such, FINRA believes the proposed desk commentary safe harbor would allow firms to leverage existing compliance efforts for the institutional debt research exemption.

Request for Comment

FINRA welcomes all comments on the proposal. We specifically request comments on whether other requirements of Rule 2241 or Rule 2242 should apply to desk commentary subject to the safe harbor, such as the requirement to disclose an analyst's personal holdings in a subject company? In addition, are there specific ordinary course activities engaged in by authors of desk commentary related to investment banking transactions that would be precluded by the conditions of the safe harbor?

We also request comments on the economic impact and expected beneficial results of the proposal:

1. What economic impacts, including costs and benefits, would be associated with the proposal? To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models?
2. Is the proposal well designed to maintain the information flow from the trading desk to institutional customers while managing the most serious conflicts of interest that may arise in the preparation of desk commentary? Are the proposed conditions appropriate given the context and scope of the communications and the experience and sophistication of the institutional customers receiving the desk commentary?
3. How would the proposal change business practices and competition among firms producing desk commentary? What second order impacts could result?

We request data and other quantitative measures in support of comments where possible.

Endnotes

1. See [Regulatory Notice 17-14](#) (April 2017).
2. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See [Notice to Members 03-73](#) (November 2003) (Online Availability of Comments) for more information.
3. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
4. For ease of reference, the *Notice* will use the term “research report” to refer to both a “research report” under Rule 2241 and a “debt research report” under Rule 2242.
5. Rule 2242(j) provides an exemption from many of the rule’s provisions for debt research distributed solely to eligible institutional investors. While similar to the proposed safe harbor, the institutional debt research exemption includes research not only from the desk but also from the research department. See *infra* at page 9 for a discussion of the differences.
6. While the proposal would prohibit eligible desk commentary from including the author’s own rating, price target or earnings estimate, it would not preclude referencing a rating, price target or earnings estimate in other published research, including from the firm’s own research department, or discussing the directional effect of an event on an issuer’s rating, price target or earnings.
7. FINRA notes that all desk commentary, whether or not eligible for the limited safe harbor, remains subject to the applicable provisions of FINRA Rule 2210 (Communications with the Public).
8. Compliance with a specified provision as a condition for the safe harbor would not be required of a firm that is already exempt from the provision pursuant to the exemptions for members with limited investment banking or limited principal trading activity.
9. As with the institutional debt exemption, compliance with this safe harbor condition would not require physical separation between persons who produce eligible desk commentary and sales and trading and principal trading department personnel, but absent such physical barriers, firms must implement and document other policies and procedures to achieve compliance with this condition. See Research Rules FAQs, Separation Requirements FAQ 1, available at <http://www.finra.org/industry/faq-research-rules-frequently-asked-questions-faq#separation>.

In the context of desk commentary, FINRA does not interpret “pressure” by sales and trading or principal trading personnel to exist merely because a firm produces desk commentary on securities in which it trades or the authors of desk commentary report to such personnel (or investment banking personnel to the extent not otherwise prohibited). Although FINRA does not interpret this requirement to require altering a firm’s internal reporting lines, a firm must put in place policies and procedures reasonably designed to ensure that investment banking personnel or sales and trading and principal trading personnel do not overtly pressure a person who produces desk commentary to express a particular view.

10. FINRA understands that sales and trading and principal trading personnel have an important role to play in educating other firm personnel and investors. Consistent with existing guidance for research analysts, sales and trading and principal trading personnel who publish desk commentary pursuant to the safe harbor may listen to or view a live webcast of a transaction-related road show or other widely attended presentation by investment banking to investors or the sales force from a remote location, or another room if they are in the same location. *See NASD Notice to Members 07-04* (January 2007). *See also* Securities Exchange Act Release No. 73622 (November 18, 2014), 79 FR 69939 (November 24, 2014) (Notice of Filing File No. SR-FINRA-2014-047); SEA Release No. 73623 (November 18, 2014), 79 FR 69905 (November 24, 2014) (Notice of Filing File No. SR-FINRA-2014-048).
11. This condition would not prohibit a person in the sales and trading or principal trading department from engaging in ordinary course communications related to the distribution of securities in an offering, including, for example, forwarding written materials from the syndication desk to customers, provided that the person was not *concurrently* publishing desk commentary related to the issuer or the investment banking services transaction. The fact that a person may have previously published desk commentary related to the issuer does not prohibit that person from engaging in the ordinary course communications related to the offering, provided that such commentary ceases during the offering.
12. This prohibition modifies the provisions in Rules 2241(b)(2)(N) and .05 and 2242(b)(2)(N) and .05, which permit prepublication review by subject companies of draft sections of research reports for verification of facts. FINRA believes it would be inconsistent with the scope and temporal nature of desk commentary to permit such review.
13. This disclosure would be required only if the firm maintains a proprietary trading desk or trades on a discretionary basis on behalf of some customers and those interests sometimes are contrary to the recommendations in desk commentary.
14. This requirement would not prohibit a firm from compensating a person in the sales and trading or principal trading department in the form of sales credits in connection with the distribution of securities in an offering, provided that the person had not published desk commentary related to those investment banking services transactions.
15. FINRA believes this approach is consistent with the institutional debt research exemption, where the corresponding investment banking conflict management provisions in Rule 2242 do not apply.