Chapter 49

Investment Banking Compliance

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§ 49:1 Information

§ 49:1.1 *Insider Trading*

[A] Generally

Traditionally, insider trading has been the largest and most important compliance issue for persons involved in investment banking. Insider trading is the trading of a company's securities by persons in possession of nonpublic information about that company. Insider trading can take place legally, such as when corporate insiders buy and sell securities in their own companies in compliance with the regulations governing such trading and their own internal company guidelines, and illegally, such as when corporate insiders with material nonpublic information use that information to make profits or avoid losses.[1]

"Material information" has been defined by the U.S. Supreme Court as information where: (i) there is a "substantial likelihood" that a "reasonable investor" would consider the information important in making an investment decision; (ii) the disclosure of the information would be "viewed by the reasonable investor as having significantly altered the 'total mix' of information made available";[2] or (iii) the disclosure of the information is "reasonably certain to have a substantial effect on the market price of the security."[3]

The U.S. Securities and Exchange Commission (SEC) has described "nonpublic information" as information that has not been disseminated or made available to investors generally.[4]

Sources of inside information include corporate officers or employees, corporate clients, corporate borrowers, non-corporate entities, such as government agencies, principal investments, corporate insiders, institutional investors, and research.[5]

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1. Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 2000 WL 1201556, at *24, n.125 (Aug. 15, 2000) [hereinafter Selective Disclosure and Insider Trading Release].
2. Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988), quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976).
3. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980), quoting TSC Indus., Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976).
4. Selective Disclosure and Insider Trading Release, *supra* note 1.
5. SEC OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, STAFF SUMMARY REPORT ON EXAMINATIONS OF INFORMATION BARRIERS: BROKER-DEALER PRACTICES UNDER SECTION 15(G) OF THE SECURITIES EXCHANGE ACT (Sept. 27, 2012) [hereinafter OCIE MNPI Report]. *See also* Shearman & Sterling, OCIE Staff Publishes Summary Report on Broker-Dealer Practices Relating to Information Barriers (Oct. 9, 2012), http://www.shearman.com/~/media/Files/NewsInsights/Publications/2012/10/OCIE-Staff-Publishes-Summary-Report-on-BrokerDea__/Files/View-full-memo-OCIE-Staff-Publishes-Summary-Repo__/FileAttachment/OCIEStaffPublishesSummaryReportonBrokerDealerPra__.pdf.

[B] Legal Framework

[B][1] Securities Exchange Act § 10(b)

Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated thereunder prohibit the misuse of material nonpublic information in connection with the purchase or sale of securities. Courts have interpreted section 10(b) and Rule 10b-5 to prohibit the purchase or sale of securities on the basis of material nonpublic information where there has been a breach of a duty to disclose such information or abstain from trading.[6]

Rule 10b5-1, promulgated in 2000, provides affirmative defenses to violations of Rule 10b-5, including a provision that a broker-dealer or other entity may "demonstrate that a purchase or sale of securities is not 'on the basis of' material nonpublic information" if the person making the investment decision was not aware of the information, and the broker-dealer or other entity had implemented reasonable policies and procedures to ensure that investment decisions would not be based on such information.[7] In the release accompanying the rule, the SEC noted that a broker-dealer could reduce the risk of trading desk awareness of material nonpublic information by

6. In addition to the classic case of insider trading, where a corporate insider trades in securities on the basis of material nonpublic information, liability under Rule 10b-5 can arise when information has been misappropriated. Misappropriation occurs when an outsider trades in violation of a duty of confidentiality and loyalty owed to someone else. *See* United States v. O'Hagan, 521 U.S. 642 (1997); Chiarella v. United States, 445 U.S. 222 (1980). Rule 10b5-2 "provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the 'misappropriation' theory of insider trading." 17 C.F.R. § 240.10b5-2 (2000). In United States v. Newman, 773 F.3d 438 (2d Cir. 2014), the Second Circuit declined to accept the theory that a defendant who receives information indirectly—a so-called "remote tippee"—need not know that the insider had disclosed material non-public information in exchange for a personal benefit (while the government petitioned for *certiorari* with respect to certain aspects of this decision, it did not do so on the question of whether a remote tippee has to know about the benefit conferred on the insider; the Supreme Court rejected the petition in any event). Because industry participants frequently receive information indirectly, the *Newman* decision has caused some institutions to consider whether their policies should define insider trading more narrowly such that trading is prohibited only when the recipient of information knows that it was disclosed in breach of duty *and* in exchange for a benefit. In fact, however, the *Newman* decision's application in the context of investment banking compliance has thus far been limited, because investment banking compliance has traditionally ignored the question of whether the insider received a benefit.
7. 17 C.F.R. § 240.10b5-1(c)(2) (2000).

"segregat[ing] its personnel and otherwise us[ing] information barriers so that the trader for the firm's proprietary account is not made aware of the material nonpublic information."[8]

[B][2] Insider Trading and Securities Fraud Enforcement Act

In the 1984 Insider Trading Sanctions Act (ITSA), Congress gave the SEC more power to combat insider trading.[9] In 1988, amid several insider trading scandals, Congress passed the Insider Trading and Securities Fraud Enforcement Act (ITSFEA).[10] Congress intended the act to "augment enforcement of the securities laws, particularly in the area of insider trading, through a variety of measures designed to provide greater deterrence, detection and punishment of violations . . . ."[11]

ITSFEA created section 15(f) of the Exchange Act, renumbered as section 15(g) by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[12] which, for the first time, created an affirmative duty for broker-dealers to "establish, maintain and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material nonpublic information."[13]

Section 15(g) requires broker-dealers not only to implement information barriers to prevent the misuse of material nonpublic information, but also to regularly review and to vigorously enforce the barriers. ITSFEA expanded the enforcement power of the SEC by allowing it to seek sanctions against firms that fail to have adequate policies and procedures in place, even if no actual trading violations occur.[14] ITSFEA does not expressly outline the types of procedures necessary to avoid liability; however, the ITSFEA House Report cited some examples, including:

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8. Selective Disclosure and Insider Trading, *supra* note 1, at *24, n.125.
9. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2; 98 Stat. 1264 (1984).
10. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).
11. H.R. REP. NO. 100-910, at 7 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044 [hereinafter ITSFEA House Report].
12. Pub. L. No. 111-203, 124 Stat. 1376 (2010).
13. Securities Exchange Act of 1934, 15 U.S.C. § 78o(f) (section 15(g)).
14. For an example of a case in which the SEC brought charges under section 15(g) without identifying trading violations, see Litigation Release No. 20,551 (May 1, 2008) (announcing the filing and settlement of a civil complaint against Chanin Capital LLC for failure to establish, maintain, and enforce adequate procedures under section 15(g)).

- restraining access to files likely to contain material nonpublic information;
- providing continuing education programs concerning insider trading regulations;
- restricting or monitoring trading in securities about which firm employees possess material nonpublic information; and
- diligently monitoring trading for firm or individual accounts.[15]

Following the passage of ITSFEA, the SEC Division of Market Regulation (the "Division" (now the Division of Trading and Markets)) published a report in March 1990 of its review and analysis of broker-dealers' information barrier policies and procedures.[16] Although ITSFEA explicitly granted the SEC broad powers to mandate specific policies to be adopted by broker-dealers, the SEC provided some general observations regarding the elements of an adequate information barrier and concluded that the self-regulatory organizations (SROs)[17] were best equipped to test the adequacy of current broker-dealer policies and procedures and to formulate any required improvements or modifications.[18] Throughout its report, the Division emphasized the need to tailor a firm's policies and procedures to the nature of its businesses and the importance of a firm's compliance department to the proper functioning of the firm's information barriers. In June 1991, the NASD and the NYSE issued a Joint Memo on Chinese Wall Policies and Procedures, discussing the minimum elements necessary to create and maintain an adequate information barrier.[19]

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15. ITSFEA House Report, *supra* note 11, at 22 (reprinted in 1988 U.S.C.C.A.N. 6043, 6059).
16. *See* Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information, Fed. Sec. L. Rep. ¶ 84,520 (Mar. 1, 1990) [hereinafter 1990 SEC Market Reg. Report].
17. FINRA was formed in 2007 upon the merger of the NASD and certain divisions of the NYSE. The FINRA rulebook currently consists of both NASD rules and certain NYSE rules that FINRA has incorporated. For purposes of this outline, these rules will be referred to as NASD and NYSE rules, respectively, or where applicable FINRA rules. FINRA also has incorporated the interpretive guidance issued by the NASD and the NYSE related to NASD rules and the incorporated NYSE rules.
18. *See* 1990 SEC Market Reg. Report, *supra* note 16.
19. NASD/NYSE Joint Memo on Chinese Wall Policies and Procedures, NASD Notice to Members 91-45 (June 21, 1991), NYSE Information Memo 91-22 (June 28, 1991) ("NASD/NYSE Joint Memo").

§ 49:1.2 *Information Barriers*

[A] Generally

Multiservice firms establish information barriers[20] to restrict the flow of material nonpublic information between employees who regularly acquire or develop that type of information, such as investment bankers, and employees who buy, sell, or recommend the securities to which the information relates. Information barrier policies and procedures initially adopted by firms generally focused primarily on the control of material nonpublic information obtained by investment bankers in connection with corporate transaction and advisory assignments. However, there are other potential sources of material nonpublic information that require careful handling.[21]

[B] Effective Information Barriers: Minimum Elements

Firms have flexibility to tailor information barriers, but the SEC and SROs have set certain minimum elements of an effective information barrier program.

[B][1] Written Policies and Procedures

Information barrier policies and procedures must be incorporated in a firm's procedure and policy manuals and must restrict material nonpublic information to employees who have a "need to know" such information. These procedures include: policy statements, restrictions on access to records and support systems for sensitive departments, and supervision of all interdepartmental communications ("wall-crossing") involving material nonpublic information. There is leeway to compartmentalize organizations within the firm (such as between the investment banking business and the sales/trading/research businesses), but it is still important to incorporate a "need to know" policy within organizations. Information can be subject to non-disclosure requirements even if it is confidential, but not material. As a result,

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20. The legislative history of ITSA reveals strong support for the idea that effective information barriers can provide a defense to alleged insider trading violations. The then-Chairman of the SEC stated in a letter to Congress that "[I]t is . . . important to recognize that, under both existing law and the bill, a multiservice firm with an effective Chinese wall [or information barrier] would not be liable for trades effected on one side of the wall, notwithstanding inside information possessed by firm employees on the other side." Letter from John S. R. Shad to Rep. Timothy E. Wirth (June 29, 1983), *reprinted in* H.R. REP. NO. 98-355, at 28 n.52 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2301 n.52.
21. For example, research departments' knowledge of to-be-published research reports can constitute material nonpublic information.

some firms have imposed the "need to know" policy more broadly to apply to all types of confidential information.

[B][2] Wall-Crossing Procedures

Firms must have "wall-crossing" procedures designed to facilitate situations that require an employee to cross an information barrier. Wall-crossings must be controlled and monitored, preferably by the compliance departments and must be specifically documented in writing and records retained.

[B][3] Restricted List and Watch List

The restricted list is a list of issuers whose securities or other financial instruments are subject to restrictions on sales, trading, or research activity. An issuer or security may be placed on the restricted list in order to reinforce a firm's information barrier, to comply with trading practices and other rules, to avoid the potential appearance of impropriety, or to meet other compliance or regulatory objectives. When an issuer appears on the restricted list, certain sales, trading and research activities involving that issuer's securities or other financial instruments may be restricted. Restricted activities may include: proprietary trading, including market-making; solicitation of client orders; the recommendation of the issuer's securities; and transactions for any employee, associated person, or related account with respect to the related securities or financial instruments. The restricted list is usually maintained by a firm's compliance department, or by an institutional control room.

The watch list (sometimes called the grey list) is a confidential list of issuers or securities about which a firm may have received or may expect to receive material nonpublic information, or about which the firm expects a reason to monitor activities. The placement of an issuer or security on the watch list generally will not affect sales and trading activities, except by personnel who have access to material nonpublic information that may be the reason for the addition to the watch list. Trading in and research regarding watch-list securities or issuers are subject to surveillance by the firm's compliance department. The contents of the watch list and any related restrictions that may be imposed by the legal or compliance department are extremely confidential, and access to the watch list is very limited.

Firms that conduct both investment banking and research or arbitrage activities must maintain some combination of restricted and watch lists, and should conduct regular reviews of trading in securities appearing on the lists.[22] The SROs set forth specific minimum

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22. Even firms that do not conduct investment banking, research, or arbitrage activities must have documented procedures to review employee and

documentation standards concerning such lists, including records of the firm's methods for conducting reviews of employee and proprietary trading, the firm's procedures for determining whether trading restrictions will be implemented and the firm's explanations of why, when and how a security is placed on or deleted from a restricted or watch list.[23] Further, the firm must adequately document how it monitors employee trading outside the firm of securities on the restricted or watch lists.

[B][4] Surveillance of Trading Activity

Firms must take reasonable steps to investigate any possible misuse of material nonpublic information, including any transactions in restricted or watch-list securities. Each investigation initiated must be documented, and should include the name of the security, the date the investigation began, an identification of the accounts involved, and a summary of the disposition of the investigation.

[B][5] Physical and Electronic Separation

Information barriers must include arrangements for reasonable physical separation of public-side businesses (for example, sales and trading) from private-side businesses (for example, investment banking) that regularly receive confidential information. Information barriers must also consider secure separation of databases and systems used by private-side businesses.

[B][6] Training and Education Programs

Firms must establish and maintain reasonable training and education programs to ensure sufficient employee understanding of federal and state securities laws, SRO requirements, and the firm's policies and procedures to prevent the misuse of material nonpublic information.

[B][7] Employee Attestation

Firms must require each employee to sign an attestation, to be maintained in the firm's files, of his or her knowledge of insider trading rules and regulations at least once during the course of employment. The SROs encourage firms to require employees in sensitive

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proprietary trading for misuse of material nonpublic information. *See* 1990 Market Reg. Report, *supra* note 16, at pt. III.

23. The NASD/NYSE Joint Memo further mandates documentation for the use of restricted and watch lists. First, the firm must develop reasonable written standards or criteria for placing a security on and deleting a security from such lists. Second, documentation must include the date and, for restricted lists, the time the security was added to or deleted from the list.

departments, such as investment banking, to sign an attestation on an annual basis.[24]

§ 49:1.3 Sales Practices; Testing-the-Waters and Gun Jumping

The SEC imposes restrictions on the ability of securities offering participants to communicate publicly about a securities offering when such an offering is contemplated or occurring. The restrictions generally apply to all forms of communications, including press releases, interviews, and social media. Violations, or "gun jumping," can result in delays of offering, fines, or sanctions by the SEC. The SEC's authority to restrict communications in this manner derives from section 5 of the Securities Act of 1933 (the "Securities Act").[25] The statute divides the offering period into three: the pre-filing period, the waiting period, and the post-effective period. Different types of communications are allowed during each period.

The Jumpstart Our Business Startups Act (the "JOBS Act") significantly eased the restrictions on offering communications by permitting emerging growth companies (EGCs) to make "testing-the-waters" oral and written communications with potential investors that are qualified institutional buyers (QIBs), as defined in Rule 144A under the Securities Act, and other institutional accredited investors. EGCs may test the waters before or after the filing of the registration statement, and may continue to test the waters during the waiting period. The JOBS Act also provides that the publication or distribution of research about an EGC that proposes to register an equity offering under the Securities Act or has a pending registration statement does not constitute an "offer" under the Securities Act.

While market sounding activities for non-EGCs continue to be undertaken with great care (in the United States, only after a registration statement is on file) to avoid section 5 "gun jumping" issues, the SEC shall alleviate some of the previous concerns about whether market sounding activity might run afoul of Rule 15c2-8(e) under the Exchange Act, which requires a broker-dealer to make available a preliminary prospectus (containing a price range) to each associated person that is expected to solicit customer orders prior to the effective date. In a JOBS Act FAQ, the SEC staff confirmed that market sounding activities consisting of seeking non-binding indications of

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24. 1990 Market Reg. Report, *supra* note 16, at pt. V. Many broker-dealers combine this attestation with the annual compliance meeting required by FINRA supervisory control rules.

25. Securities Act § 5.

interest, including number of shares at various price ranges, should not, in the absence of other factors, violate Rule 15c2-8(e).[26]

§ 49:1.4 2012 OCIE Report on the Use of Material Nonpublic Information by Broker-Dealers

In September 2012, the SEC issued the OCIE MNPI Report on information barriers, based on observations by staff of the SEC, FINRA, and the NYSE Division of Market Regulation of broker-dealer programs to protect against misuse of material nonpublic information (MNPI).[27] Examiners from the SEC examined six of the largest broker-dealers and examiners from the NYSE and FINRA examined an additional thirteen broker-dealers. The Report does not restate the conclusions of the 1990 SEC Market Reg. Report, which it confirms remain generally appropriate. Instead, it summarizes findings on sources of MNPI, Control Structures and Controls at the firms examined and makes observations about potential areas of concern and possible avenues of improvement.

[A] Sources of MNPI

The OCIE MNPI Report describes in detail the following sources of MNPI that were observed in the examinations:

- *Corporate Clients*. Broker-dealers obtain MNPI from traditional corporate clients through advisory work on M&A transactions, participating in capital markets transactions, in derivative sales functions as an adjunct to M&A and capital markets transactions, and in the credit function, in the process of reviewing and approving extensions of credit.
- *Corporate Borrowers*. Broker-dealers obtain MNPI from corporate borrowers in a number of ways, including acting as administrative agent, syndicate member, holder of loan interests, manager of a loan site, loan trading, and acting as a member of a bankruptcy committee.
- *Non-Corporates*. The Report suggests broker-dealers consider the extent to which nonpublic information obtained from government agencies may be MNPI.[28]

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26. Jumpstart Our Business Startups Act, Frequently Asked Questions About Research Analysts and Underwriters, FAQ No. 1 (Aug. 22, 2012).
27. *See* OCIE MNPI Report, *supra* note 5.
28. *See* In the Matter of Marwood Grp. Research, LLC, Exchange Act Release No. 76,512 (Nov. 24, 2015) (finding Marwood to maintain procedures reasonably designed to prevent misuse of MNPI information obtained confidentially from the government and subsequently used in research reports was considered to have a substantial risk of containing MNPI).

- *Principal Investments*. Broker-dealers may obtain MNPI from companies in which they hold a significant principal investment.
- *Corporate Insiders*. Groups within a broker-dealer may obtain MNPI through contact with corporate insiders. The Report also mentions situations in which an employee of the broker-dealer serves as board member of another company.
- *Institutional Investors*. The Report suggests that information about trades or trading strategies of institutional customers may constitute MNPI.
- *Research*. The Report suggests that nonpublic information about views, including price targets, of research analysts associated with the broker-dealer may constitute MNPI.

[B] Control Structure

[B][1] Issues Identified

The Report refers to a number of control structure issues that could raise concerns about inappropriate sharing of MNPI, including proximity of public and private-side trading groups, exceptions for special situations (for example, public-side desk "goes private" with respect to a specific security), and access without clearance (for example, "above the wall" classification for senior management).

[B][2] Control Room

The Report identifies control room practices that raised concerns, including, for example, reliance on control room or bankers to determine when and whether to place matters on watch list; absence of written guidance on when matters should go on watch list; and absence of testing. The Report suggests there is a trend to more automated solutions that are integrated with new-matter intake systems.

[B][3] "Above the Wall" Designations

The Report notes that "above the wall" designations for certain persons and groups, such as senior managers, research department, and syndicate group personnel, can create circumstances where select personnel have access to MNPI without the observance of rigid or comprehensive procedures. The Report recommends consideration of appropriate controls and surveillance for such persons.

[B][4] Materiality Determinations

The Report notes that matters are sometimes not put on the watch list due to a determination that the matter is not material. Concerns were raised about the failure to memorialize transactions deemed immaterial; failure to document the materiality assessment; and absence of mechanisms to reevaluate such a determination based on changed circumstances.

[B][5] Oversight of Non-Transactional Sources of MNPI

The Report stresses the need to consider the potential for receipt and misuse of MNPI outside the transactional context. It raises questions about whether such information should be forwarded to the control room, and suggests there is risk associated with relying on the self-reporting of public-side employees who received MNPI.

[B][6] Compliance with Oral Confidentiality Agreements

The Report notes with concern that deals governed by oral confidentiality agreements confirmed through emails, such as overnight deals, can lack MNPI protections, because in such cases the control group's ability to conduct appropriate monitoring is diminished.

[B][7] Personal Trading Problems

The Report notes that some broker-dealers generally exempt employees' managed accounts from the pre-clearance process. The Report expresses concern about firms that permit employees to use any external manager and do not conduct any scrutiny as to the ability of the employee to influence trading in the account. The Report also criticizes firms for their weak responses to employees' repeated failures to obtain pre-clearance prior to personal trading.

[C] Access Controls

[C][1] Limiting Authorized Access

The Report stresses the need for controls around information sharing and wall crossing. It expresses concern about undocumented informal discussions between private and public-side personnel. It also raises issues about controlling access to computerized document management systems and databases, even those that are limited to private-side employees (need-to-know basis).

[C][2] Preventing Unauthorized Access

The Report raises concerns regarding the absence of walls and/or restrictions of access to private-side support areas like information technology and operations.

[C][3] Other Control Issues

The Report discusses the need for controls over third-party sources of MNPI like loan sites and virtual data rooms. It raises concerns about information received based on oral or informal confidentiality undertakings, and reliance on written policies and self-reporting in such situations. It also raises concerns about the quality of processes, documentation, and monitoring of access to MNPI by third parties (wall crossings, market color, virtual data rooms, and loan sites set up for syndications).

[C][4] Surveillance

The Report suggests that broker-dealers should be enhancing the scope of surveillance to broaden traditional notions of where MNPI might be misused. It suggests that surveillance programs should be expanded to detect patterns of behavior rather than just "point-in-time" violations, and identifies the need to properly document the resolution of surveillance matters.

[D] Controls Perceived to Be Effective

[D][1] Control Room Monitoring

The Report commends the use of independent checks, such as automatic (and automated) surveillance by and notices from conflicts systems, to ensure prompt notification of the potential of employees possessing MNPI.

[D][2] Information Barriers

The SEC staff also applauds the use of formal, documented processes for taking public-side employees over information barrier walls. In addition, the Report commends the use of controls around conversations between investment bankers and institutional investors, such as prequalification of the investor; advance submission of questions subject to discussion; mandatory participation by senior bankers; and the establishment of physical and technological barriers between departments that routinely have access to MNPI (for example, investment banking, credit and private equity, research covering corporate issuers, conflicts and control room, and printing and production).

[D][3] Surveillance

The Report commends the tailored and proportionate expansion of surveillance by broker-dealers with reference to the range of transactions and instruments being reviewed (for example, credit default swaps, total return swaps, warrants, and bond options).

[E] Conclusion

The Report emphasizes that broker-dealers should continually reassess both potential sources and uses of MNPI, and whether reasonable controls are in place. "Practices that are sufficient for a broker-dealer at one time may not adequately comply with its legal obligations at other times. Importantly, written and implemented controls that are deemed reasonable may likely vary among broker-dealers depending on factors such as size and business model."

§ 49:1.5 Selective Disclosure by Issuers: Regulation FD

Regulation FD requires all U.S. reporting companies to make a public announcement or filing with the SEC of any material non-public information they disclose on a non-confidential basis to certain persons outside the company, including securities market professionals and large money managers, as well as investors, where it is reasonably foreseeable that the investor would trade on the basis of the information.[29]

Non-U.S. companies are exempted, but expected to conduct themselves in accordance with the basic principles underlying Regulation FD. The SEC has stated that it may extend the same or similar obligations to those issuers in the future. Non-U.S. companies should be aware that their disclosures remain subject to anti-fraud provisions, including insider trading prohibitions. Non-U.S. companies should also be aware of their obligation under NYSE or Nasdaq listing standards to make timely reports of material information.[30] Selective disclosure may also implicate other regulatory regimes applicable to non-U.S. companies, such as the EU Market Abuse Regulations.

Investment banks need to be sensitive to a client's obligation not to make selective disclosures and avoid situations that could lead to potential violations. Where violations occur, as with FCPA violations or certain other laws and regulations that are the subject of enforcement actions, cooperation with the SEC or the Department of Justice (the "DOJ") will often be looked upon favorably by the enforcement

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29. 17 C.F.R. §§ 243.100–.103 (2001).
30. *See* Final Rule: SEC Release No. 34-43154 [Selective Disclosure and Insider Trading], at text accompanying nn.76, 77.

agency and could prevent enforcement action.[31] Companies aware of violations should consider carefully the potential advantages of self-reporting violations (where that is not already mandated by applicable law) and discuss their options with outside counsel as appropriate.

§ 49:1.6 Practical Issues in Managing Confidential Information

Information barrier policies and procedures initially adopted by firms in response to section 15(g) focused primarily on the control of material nonpublic information obtained by investment bankers in connection with corporate transactions and advisory assignments. However, there are other potential sources of material nonpublic information that require careful handling, as discussed below.

[A] Expert Networks

Market participants sometimes access "expert network" firms to help market professionals and research analysts to better understand complex developments in specialized industry areas by giving them access to expert consultants. These interactions involve risks if the consultants have access to material nonpublic information. Market participants should evaluate their policies and procedures in this area and carefully evaluate situations in which expert consultants are used.

The SEC has brought a number of insider trading cases involving expert networks, charging employees of expert network firms, expert consultants and hedge fund portfolio managers and analysts.

Even with the appropriate assurances, use of experts who are employed by public companies (or private companies that service or supply them) may be problematic. It is important to consider that even where the expert is not employed by a public company, trouble can arise from using expert consultants who purport to have specific financial figures or other data from undisclosed sources. In addition, even where the ultimate source of the information provided by experts is unknown,

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31. In 2013, the SEC chose to forgo prosecution of First Solar, Inc., a company that was involved in the Regulation FD violation because of its extraordinary cooperation with the investigation. First Solar had already cultivated an environment of compliance through the use of a disclosure committee that focused on compliance with Regulation FD. As a result, it immediately discovered the selective disclosure and promptly issued a press release the next morning before the market opened. The company also quickly self-reported the misconduct to the SEC and, concurrently with the SEC's investigation, undertook remedial measures such as additional Regulation FD training for employees responsible for public disclosure. SEC Press Release 2013-174, SEC Charges Former Vice President of Investor Relations with Violating Fair Disclosure Rules (Sept. 6, 2013), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539799034.

receipt of and trading on that information may be scrutinized. It is frequently difficult to determine whether the information obtained from experts will be considered to have been provided in breach of a duty.

[B] Hedge Fund Interaction—Market Sounding

As with any discussions with public-side persons, investment bankers need to be vigilant when interacting with hedge funds that trade public securities. The various ways in which investment bankers may interact with hedge funds include: (i) "testing the waters" with respect to a possible issuance of securities,[32] (ii) investment in private equity and private placements of securities, and (iii) communications with hedge funds seeking a better understanding of the current state and future direction of an industry or market.

Ordinarily, trading clients talk to public-side traders to get a sense of the market. However, on occasion, a hedge fund may reach out to investment bankers in order to gain a better understanding of the current state and future direction of an industry or market.

[C] Hedge Fund Access to Corporate Executives

Increasing attention has been called to the potentially market-moving nature of information shared in meetings and calls between hedge funds and corporate executives.[33] In many cases, such meetings have been facilitated by investment bankers whose firms have trading relationships with hedge funds as well as have extensive client relationships with public companies. Because these meetings have the potential of violating Regulation FD or applicable insider trading laws, investment banks should evaluate their policies and procedures relating to facilitating these meetings and for banker participation.

In January 2012, the U.K. Financial Services Authority (FSA) imposed a financial penalty of £3,638,000 on David Einhorn, President of Greenlight Capital, for engaging in market abuse in breach

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32. Securities Act § 5(d), adopted in the JOBS Act, provides that an emerging growth company, as defined in the act, or any person authorized to act on its behalf may engage in oral or written communications with potential investors that are qualified institutional buyers as defined in Rule 144A or institutional accredited investors as defined in Regulation D, for the purpose of determining interest in the offering, either prior to or following the date of filing of a registration statement. In the past, these "sounding" activities were undertaken with great care (in the United States only after a registration statement was on file), to avoid running afoul of section 5 "gun jumping" issues. The JOBS Act has removed the section 5 concerns for testing the waters activities that comply with the foregoing requirements. This is used in IPOs; follow-on offers would require Regulation FD compliance.
33. *See, e.g.*, David Enrich and Dana Cimilluca, *Banks Woo Funds with Private Peeks*, WALL ST. J., May 16, 2011.

of insider information laws.[34] The fine related to trading of shares and contracts for difference in Punch Taverns plc in June 2009. Greenhorn was invited to be a wall-crossed participant in an equity offering contemplated by a public company. Subsequently, a corporate broker arranged a meeting between the company and Einhorn on a non-wall-crossed basis. Immediately after the call, Greenlight traders reduced the firm's position in the company's shares pursuant to Einhorn's instructions. When the company announced its transaction, its shares fell by 29.9% and Greenlight avoided a loss of approximately £5.8 million. The FSA alleged that during the call, which was expressly set up on a non-wall-crossed basis, Einhorn received inside information that the company was at an advanced stage of the process toward the issuance of a significant amount of new equity in order to repay a convertible bond and create headroom under financial covenants. According to the FSA, it should have been apparent that the information was confidential and price sensitive, and gave rise to legal and regulatory risk. The FSA concluded that Einhorn committed an error in judgment in deciding to sell shares without first seeking compliance or legal advice.

The FSA brought a separate action against a trader at Greenlight's UK entity who also served as money laundering and compliance officer.[35] The FSA found that the Greenlight trader failed to question and make reasonable inquiries prior to effecting the sale of the company's shares even though he was told that the decision to sell was made after a meeting with company's management and that negative information would have been received if Greenlight had been wall-crossed. The FSA also faulted him for not following up after the announcement, which they said should have alerted him to the risk of market abuse. The trader was fined £130,000 and banned from performing anti-money laundering and compliance functions.

The FSA also brought a separate action against a trading desk director at JPMorgan Cazenove, who was instructed to execute sales on behalf of Greenlight. He was fined £68,000 for failing to recognize and alert the compliance department that there were reasonable grounds, following the announcement of the transaction, to suspect that the sales constituted insider trading or market abuse.[36]

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34. Greenlight Capital Inc. Decision Notice, (2012) (F.S.A.), http://www.fsa.gov.uk/static/pubs/decisions/dngreenlight-capital.pdf; David Einhorn Decision Notice, (2012) (F.S.A.), http://www.fsa.gov.uk/static/pubs/decisions/dn-einhorn-greenlight.pdf.
35. Alexander Edward Ten-Holter Final Notice, (2012) (F.S.A.), http://www.fsa.gov.uk/static/pubs/final/tenholter-greenlight.pdf; Caspar Jonathan William Agnew Final Notice, (2011) (F.S.A.), http://www.fsa.gov.uk/static/pubs/final/caspar-agnew.pdf.
36. *Id*.

In 2012, the SEC brought charges against Goldman Sachs under section 15(b) of the Exchange Act out of concern that its weekly "huddles" of traders created a serious and substantial risk of sharing material nonpublic information in violation of section 15(g).[37] Huddles were a practice in which Goldman's equity research analysts met to provide their best trading ideas to firm traders and a select group of top clients. Analysts' contributions to huddles and calls with top clients were discussed in performance reviews and in connection with analyst evaluations. The SEC charged that Goldman did not establish, maintain, and enforce adequate policies and procedures to prevent any misuse of material nonpublic information concerning Goldman's published research. Goldman agreed to settle the charges and pay a $22 million penalty. Goldman also agreed to be censured, to be subject to a cease-and-desist order, and to review and revise its written policies and procedures to correct the deficiencies identified by the SEC. Goldman also entered into a settlement with FINRA for supervisory and other failures related to the huddles.

In 2013, the Office of the Secretary of the Commonwealth of Massachusetts entered a consent order against Citigroup for the provision by a research analyst of confidential nonpublic information to hedge fund and institutional clients prior to publication in a research report.[38] Citigroup subsequently entered into a settlement with the Massachusetts Securities Division. Without admitting or denying liability, Citigroup agreed to (1) pay a civil penalty of $30 million; (2) conduct a review of, and revise as necessary, policies and procedures applicable to the research department; (3) establish a mandatory training program for research analysts; and (4) make annual certifications regarding compliance with the consent order for a period of three years.

[D] Use of Confidentiality Agreements

While confidentiality agreements can provide a secure method by which investment bankers can disclose material nonpublic information, these agreements must be carefully constructed and contain explicit language concerning duties and expectations.

SEC v. Cuban,[39] an insider trading case from 2009, specifically addressed the provisions of a confidentiality agreement and whether it explicitly or implicitly imposed a duty not to disclose material nonpublic information, and a duty not to trade on or otherwise use

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37. In the Matter of Goldman, Sachs & Co., Release No. 34-66791 (Apr. 12, 2012).
38. Consent Order, In the Matter of: Citigroup Global Markets Inc., Docket No. 2013-0014 (Oct. 2, 2013).
39. SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009).

this information. The SEC alleged that the actions of Mark Cuban constituted insider trading after he sold shares of the company in which he owned a minority stake upon learning of a planned stock offering from the CEO. Cuban's quick trade saved him more than $750,000 in losses. The district court granted Cuban's motion to dismiss, finding that while the SEC alleged that Cuban had entered into an agreement not to disclose the information, it did not allege that he had expressly or implicitly agreed not to use the information. However, the district court's decision to dismiss has since been vacated on appeal.[40] The Fifth Circuit noted that it was plausible that each of the parties understood, if only implicitly, that Cuban was being provided the terms and conditions of the offering solely for the purposes of evaluating whether he would participate in the offering, and that Cuban could not use the information for his own personal benefit. The matter was tried in the district court in 2013, and a federal jury found Cuban not guilty.

The SEC staff's position on trading while in possession of this kind of information has not changed as a result of the case.

§ 49:1.7 Personal Trading Procedures

A critical issue facing investment banking compliance is the protection of material nonpublic information—particularly with respect to forthcoming transactions—that is in the possession of the investment bank. All investment banks are expected to maintain policies and procedures reasonably designed to protect the firm's MNPI. Insider trading procedures should encompass the following measures:

- *Education*. The training of both banking and compliance personnel is an integral part of any program seeking to ensure the protection of MNPI. Training should include an explanation of what constitutes nonpublic information, the determinants of materiality, and the "disclosure or staleness" standards for the resumption of trading. Training will also generally sensitize personnel to the operation of the specific firm's "watch" and/or "restricted" lists.

- *Control of information*. Procedures should specify (a) the names in which the receipt of MNPI is identified (or controlled) and brought to the attention of senior banking and/or compliance personnel; (b) how MNPI is recorded; and (c) how "watch" and "restricted" procedures operate to establish appropriate walls, and/or prohibitions on trading or other activity due to the possession of the MNPI.

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40. SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010).

- *Pre-Clearance of Trading*. The requirement of all personnel to pre-clear personal trading on a trade-by-trade basis, or the exceptions from such a requirement, should be addressed.
- Creation of procedures that are reasonably designed to mitigate possible conflicts or the appearance of conflicts with client transactions, manipulation, fraud, insider trading, or other violations of the federal securities laws, and the review of trading inside and outside the firm by covered personnel to detect the same.
- Initial and annual certification of personal holdings, accounts, and compliance.
- Reporting of all personal trades inside or outside of the firm.
- Records that are sufficient to permit the firm to test, audit, and demonstrate compliance with applicable law and regulation.
- *Protection of electronic systems and records*. Cybersecurity has become a core aspect of investment banks' protection of MNPI. Cybersecurity is reviewed below at section 49:12.

§ 49:2 Conflicts and Related Disclosures

§ 49:2.1 Dealing with M&A Transaction Conflicts

[A] Generally

In M&A, investment bankers are likely to face a variety of potential conflicts in which their interests diverge from those of their clients. For example, an investment banker hired to explore strategic alternatives might have worked with potential bidders on prior matters or might have personal ties with those companies' employees; the banker or his or her firm might be invested in certain bidders or value those companies as lucrative clients; and, perhaps even often, a banker will view one strategy as requiring significantly more of his or her services than would another.

Courts are acutely aware of these conflicts and have in recent years dealt with them severely. These legal developments create a high degree of litigation risk over even conflicts that unsuspecting industry participants might consider minor.

The approaches that multi-service investment banks use to avoid and mitigate their conflicts include:

(i) Conflict identification;

(ii) Engagement letters;

(iii) Disclosure and consent;

(iv) Engaging co-advisors and co-financers; and

(v) Developing standards for frequent areas of conflict.

[A][1] Conflict Identification

Firms have become increasingly focused on identifying sources of potential conflict. In a widely circulated report, Goldman Sachs noted that conflicts may arise from representing clients in particular roles, from representing other clients, and from the firm's own proprietary interests.[41]

[A][2] Engagement Letters

Investment banks often use engagement letters to mitigate their conflicts. These documents are provided to clients upon the start of each new project and they outline the scope of the services to be rendered; importantly, they can also be used to specifically address the firm's potential conflicts and the firm's related ability to take on additional roles in the transaction.

[A][3] Disclosure and Consent

Fairness opinions must include disclosures of all material relationships. Securities offerings or proxy solicitations should also contain robust conflicts disclosures.

[A][4] Co-Advisors and Co-Financers

A company may retain an independent co-advisor early in the M&A transaction to cure otherwise litigable advisor conflicts. Retaining a co-advisor allows directors to rely on the company's conflicted primary advisor's M&A services without appearing to violate their duty of care.

[A][5] Standards for Frequent Areas of Conflict

Firms often develop standard policies and procedures for dealing with the types of conflicts that they most frequently encounter. These standards help firms decide if existing conflicts prevent them from rendering services such as fairness opinions.

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41. *See, e.g.*, GOLDMAN SACHS BUSINESS STANDARDS COMMITTEE, REPORT OF THE BUSINESS STANDARDS COMMITTEE (2011), http://www2.goldmansachs.com/who-we-are/business-standards/committee-report/business-standards-committee-report-pdf.pdf.

[B] Stapled Financing

In a sell-side process, the seller sometimes offers an acquisition financing package to all potential buyers competing in the auction process ("stapled financing"). The financing is usually arranged by the same investment bank that is serving as the seller's financial advisor. The investment bank participating in this arrangement therefore earns fees from both sides of the transaction—M&A advisory fees from the seller, and fees for commitment letters, bridge loans, and underwriting services from the buyer. Fees for financing often significantly exceed total fees of the investment bank for the M&A assignment. Consequently, there is a potential conflict of interest for the investment bank that acts on both sides of the transaction: it is in the investment bank's financial interest to recommend a buyer that has committed itself to the stapled financing package, even if there are higher bids.

[C] Delaware Chancery Court Cases

Beginning in 2005, the Delaware Chancery Court has addressed issues relating to the conflicts of interest associated with stapled financing.

In the 2005 *Toys "R" Us* stapled financing case,[42] the Delaware Chancery Court recognized that stapled financing may be consistent with the best interests of the target company (that is, the sell-side) by inducing more bidders to take the risk of an acquisition. Nevertheless, the court's opinion advised "investment banks representing sellers not [to] create the appearance that they desire buy side work, especially when it might be that they are more likely to be selected by some buyers for that lucrative role than by others."[43]

In the *Del Monte* case,[44] the Delaware Chancery Court granted a preliminary injunction against the target company's board of directors, preventing its members from voting to sell the company to a private equity–led sponsor group. The injunction was based on the directors' breach of their fiduciary duties, which in the court's view was caused by tainted financial advice based on the advisor's conflict of interest related to its financing of the buy-side. The advisor's conflict was further exacerbated by its various other acts and omissions.

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42. *In re* Toys "R" Us, Inc., S'holder Litig., Consol. No. 1212-N (Del. Ch. June 24, 2005).
43. *Id*. at 54 n.46.
44. *In re* Del Monte Foods Co. S'holder Litig., Consol. No. 6027-VCL (Del. Ch. June 27, 2011). *See also In re* El Paso S'holder Litig., 41 A.3d 432 (Del. Ch. 2012).

In the *Rural/Metro* case,[45] the Delaware Chancery Court found the financial advisor liable for aiding and abetting the board of director's fiduciary breach in connection with the company's sale to a private equity firm. The adviser was held liable even though the board members were not, as a result of statutory exculpation. The court found that despite the involvement of a co-advisory firm and the execution of an engagement letter, the financial advisor was motivated by a substantial and undisclosed conflict of interest arising out of a desire to provide buy-side financing. The court also held that a general acknowledgment in the engagement letter regarding the extension of acquisition financing by the financial advisor did not insulate it from liability.

In the *Zale* case,[46] however, the Delaware Supreme Court affirmed the dismissal of an aiding and abetting claim against a financial advisor, finding that the advisor's conflict had been cured by the informed votes of the board of directors and the disinterested shareholders. Dismissing the claim against the advisor meant that the transaction was fully covered by the business judgment rule. The court noted that its finding would be different in the presence of bad faith or disloyalty.

[D] Best Practices in Dealing with M&A Transaction Conflicts

Actual or potential conflicts should, in appropriate situations, be disclosed to shareholders because such conflicts will be material to the shareholders' decision about whether to approve the transaction. A great level of detail may need to be included regarding such conflicts. Conflicts are also linked to fairness opinions, because investors cannot have any confidence in a fairness opinion unless conflicts or perverse incentives that may affect the investment bank or other financial institutions are properly and fully disclosed.

§ 49:2.2 Fairness Opinions

FINRA Rule 5150 requires FINRA members who issue fairness opinions that are included in a proxy statement to disclose in the opinion any material relationships with the companies involved in the transaction (for example, offering stapled financing).

FINRA Rule 5150 also requires disclosure of the following:

- whether the advisor is being compensated with success fees;

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45. *In re* Rural/Metro Corp. S'holders Litig., Consol. No. 6350-VCL (Del. Ch. Mar. 7, 2014).
46. Singh v. Attenborough, No. 645, 2015 (Del. May 5, 2016) (en banc) (*Zale III*).

- whether a "material relationship" has existed between the investment bank and any of the parties to the transaction within the previous two years or whether the investment bank anticipates developing such a "material relationship";
- whether the company supplied the investment bank with information constituting a "substantial basis" for the fairness opinion and whether the bank independently verified the accuracy of such information; and
- whether the investment bank's fairness committee approved of or issued the fairness opinion.

FINRA Rule 5150 also requires certain procedures be implemented:

- the investment bank must develop and adhere to procedures for choosing members of its fairness committee;
- these procedures must be reviewed from time to time, and the bank must periodically review its selection of members for the committee;
- the committee must have oversight into the methodology and analysis used in determining the fairness of each particular transaction about which the bank opines; and
- the committee must assess the possibility that compensation to the company's officers and directors, relative to shareholder rewards, influenced the bank's fairness opinion.

Delaware law also imposes an obligation for directors to provide shareholders with a "fair summary" of the analysis underlying fairness opinions.[47] Increasingly, appropriate disclosure of conflicts has been highlighted as a key element of disclosure relating to fairness opinions, including disclosure related to fees, buy-side relationships and contacts and even potential buy-side business. In the *Atheros* case,[48] the Delaware Chancery Court granted a preliminary injunction preventing the target's board of directors from proceeding with a vote to approve a sale of the company to a strategic partner. The injunction was based on the inadequate disclosure by the board of the financial advisor's fee, which was largely contingent on closing of the contemplated transaction.

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47. *See* Blake Rohrbacher and John Mark Zeberkiewicz, *Fair Summary: Delaware's Framework for Disclosing Fairness Opinions*, 63 BUS. LAW. 881 (2008); and *Fair Summary II: An Update on Delaware's Disclosure Regime Regarding Fairness Opinions*, 66 BUS. LAW. 943 (2011).

48. *In re* Atheros Commc'ns, Inc. S'holder Litig., Consol. No. 6124-VCN (Del. Ch. Mar. 4, 2011).

§ 49:2.3 FINRA Guidelines on Conflicts in Product Development and Distribution

FINRA has issued guidelines relating to conflicts in the product development and distribution process.[49] These do not constitute comprehensive guidance, and are instead designed to focus on three particular areas: (i) enterprise-level frameworks to identify and manage conflicts of interest; (ii) approaches to handling conflicts of interest in manufacturing and distributing new financial products; and (iii) approaches to compensating their associated persons, particularly those acting as brokers for private clients.[50]

[A] Enterprise-Level Frameworks to Identify and Manage Conflicts of Interest

The guidelines emphasize that a satisfactory conflicts management framework requires firm oversight from top leadership. In the FINRA Conflicts Report, FINRA describes an expectation that senior leadership will define how particular conflicts can arise in the context of their particular business, and instruct and train employees on their roles and responsibilities in identifying and managing conflicts. Senior leadership must also establish an effective code of conduct.

The FINRA Conflicts Report suggests that severe conflicts should be avoided, and significant conflict issues should be reported, if and as applicable, to the firm's clients, to the CEO, and to the board under appropriate circumstances. As a best practice, a firm's conflicts should also be inventoried on a periodic basis.

[B] Conflicts of Interest in the Manufacture and Distribution of New Financial Products

Firms should establish a review process for new products that is designed to identify conflicts, and then take steps to disclose those conflicts in plain English so that customers—particularly retail customers—can understand them.

The FINRA Conflicts Report notes that "know your distributor" policies and procedures can reduce incentives to utilize distribution channels which may be associated with conflicts. In particular, FINRA notes concerns regarding the preference of proprietary products in the retail setting; in addition to conflicts that arise with respect to suitability, efforts to integrate distributors into the sales process can raise them to the level of "co-manufacturer" which could lead to

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49. FINRA, REPORT ON CONFLICTS OF INTEREST (Oct. 2013) (the "FINRA Conflicts Report"), http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf.
50. *Id*. at 1.

additional conflicts.[51] Firms should consider declining to offer new products where associated conflicts are too significant to be effectively managed.

[C] Compensation of Associated Persons

The FINRA Conflicts Report points out that compensation can be a source of conflicts. Use of "product agnostic" compensation grids can reduce incentives that could lead to conflicts. Other approaches to reducing conflicts in respect of compensation can include (i) linking surveillance of registered representatives' recommendations to thresholds in a firm's compensation structure, and (ii) setting a cap on the credit a registered representative may receive for a comparable product across providers.[52]

[D] Conclusion

The FINRA guidelines suggest best practices, and emphasize that there is no one-size-fits-all approach. Firms must tailor their conflicts management framework to their particular circumstances.

§ 49:3 Offering Issues

§ 49:3.1 Rule 506(c)

Under the Securities Act, offers to sell securities must either be registered under the Securities Act or meet an exemption from registration.[53] One exemption from registration is the safe harbor found at Rule 506 of Regulation D, which exempts an offering provided that the offering meets certain conditions. Regulation D was amended in 2013 with the addition of Rule 506(c), pursuant to the JOBS Act, to allow general solicitation of investors under certain circumstances.

Under Rule 506(c) of Regulation D, an offering that is made only to accredited investors and that is otherwise qualified under Regulation D may make use of general solicitation and advertising, so long as the issuer takes "reasonable steps" to verify that all purchases of securities are made by accredited investors or by purchasers reasonably believed by the issuer to be accredited investors at the time of the sale. Rule 506(c) took effect on September 23, 2013.

To rely on the exemption provided by Rule 506(c), issuers are required to take reasonable steps to verify that all purchases of securities are made by accredited investors or by purchasers reasonably believed by the issuer to be accredited investors at the time of the sale.

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51. *Id*. at 25.
52. *Id*. at 4.
53. SEC, ANSWERS ON REGULATION D, http://www.sec.gov/answers/regd.htm.

While these reasonable steps were not specified in the rule, the SEC adopting release[54] suggests some factors that should be carefully considered, including the nature of the purchaser, information about the purchaser, publicly available information in regulatory filings, third-party information that is reasonably reliable, verification of investor status, the nature of the offering, and the terms of the offering. The SEC also clarified that what is "reasonable" as an objective assessment depends on the particular facts and circumstances.[55]

Offerings conducted under Rule 506(c) are not considered to be public offerings, so hedge funds, private equity funds, and other similar private funds may use general solicitation in connection with the offering and remain within exemptions from registration under the Investment Company Act of 1940 (the "Investment Company Act") that generally bar public offerings of securities by such funds.

§ 49:3.2 Rule 506(d)

The JOBS Act amendments to Regulation D also included the addition of new Rule 506(d). The purpose of Rule 506(d) is to disqualify securities offerings involving felons and other "bad actors" from reliance on the safe harbor exemption from registration provided by Regulation D.[56] The rule applies to offerings under Rule 506(b) and (c) and delineates "covered" persons. If any of these covered persons commit designated "disqualifying events" (as defined below), then Rule 506(d) operates to remove the offering from the safe harbor.

Covered persons include:

- Issuer or affiliates that issue securities in the same offering;
- Directors of issuer;
- Executive officers of issuer;
- General partners and managing members of issuer;
- Any beneficial owner of 20% or more of issuer's outstanding voting equity;
- Promoters connected with issuer at time of sale (as defined in Rule 405);

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54. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Release No. 33-9415 (July 10, 2013), http://www.sec.gov/rules/final/2013/33-9415.pdf.
55. *Id.*
56. *See also* SEC Release No. 33-9414, Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, http://www.sec.gov/rules/final/2013/33-9414.pdf.

- Any person being paid, directly or indirectly, for soliciting purchasers in the offering; and
- Investment managers of issuers that are pooled investment funds.

Disqualifying events include:[57]

- Criminal convictions in connection with securities/SEC regulations or requirements;
- Court injunctions or restraining orders preventing or restraining covered persons from engaging in securities trading or conduct;
- Final orders of regulators in the context of securities trading or practice;
- SEC disciplinary orders under specified provisions of the securities laws;
- SEC cease and desist orders;
- SEC stop orders; and
- U.S. Postal Service False Representation Orders.

§ 49:3.3 Regulation M

Regulation M, promulgated under the Exchange Act, consists of six rules, described below, that prevent persons with a financial interest in a securities offering from taking certain actions that could manipulate the market for the securities being offered. The regulation applies to activities by issuers, selling security holders, underwriters, and other distribution participants and affiliated purchasers. Definitions applicable to the regulation are set forth in Rule 100.

Rules 101 and 102 make it unlawful for distribution participants and issuers, or their affiliated purchasers, to directly or indirectly bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted periods. Thus, the basic prohibition under Regulation M: a transaction participant cannot be distributing an offering, while buying at the same time.

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57. Disqualification under Rule 506(d) is not triggered by actions taken in jurisdictions other than the United States, nor is it triggered by cease and desist orders for violations of "non-scienter"-based provisions of the federal securities laws. *See* Compliance as Disclosure Interpretations 260.20 and 260.21 (Dec. 4, 2013).

There are many exceptions to this general rule for both securities and activities, but it is important to note that the scope of the exception is different under each rule. For example, Rule 101, applicable to underwriters, has an exception for actively traded securities, but the corresponding exception in Rule 102 only covers actively traded "reference securities." Under both rules, some types of debt securities are exempt. Rule 102 has fewer activities exceptions than Rule 101. Some of these exceptions include research, unsolicited transactions, and redemptions by commodity pools or limited partnerships.

Rule 103 governs passive market making activities for NASDAQ listed securities. Rule 103 sets forth explicit criteria that must be followed, including pricing limitations, purchasing capacity, displayed size, designation of bids, regulatory notification, and prospectus disclosure.

Rule 104 relates to stabilization activities. Rule 104 generally makes it unlawful for any person, directly or indirectly, to stabilize, to effect any syndicate covering transaction, or to impose a penalty bid, in connection with an offering of any security, except in accordance with the rule. The rule applies to all offerings, not just to "distributions" (that is, the rule applies even to offerings smaller than a "distribution"). It is designed to generally prevent stabilizing activities except for those done in order to try to prevent or mitigate a decline in market price of a security. The rule also imposes disclosure and recordkeeping requirements in connection with Rule 104 activities. There are some exceptions to Rule 104, including but not limited to:

- Rule 144A/Regulation S transactions;
- distributions of exempted securities as defined in section 3(a)(12) of the Exchange Act; and
- stabilization activities occurring outside the United States.

Rule 105, which is an anti-manipulation rule that is qualitatively different from other provisions of Regulation M, includes short sale restrictions that generally prohibit any person who sells short a security that is the subject of a registered offering from purchasing the offered securities from an underwriter or broker or dealer participating in the offering if the short sale was effected during a restricted time frame prior to the pricing of the security, as described by Rule 105. The Rule does not apply to offerings of nonconvertible debt securities, offerings that are not registered under the Securities Act, and best efforts offerings. In addition, there are some exceptions, including for purchases by investment companies.

§ 49:3.4 *Section 10b-5 Due Diligence Defense*

[A] Background

Section 11(a) of the Securities Act provides that parties involved in a registered public offering, including issuers and underwriters, may be held liable if the registration statement contains "an untrue statement of material fact" or omits "to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Section 11(b) provides a defense, known as the "due diligence" defense, for underwriters and other persons (other than the issuer) who conduct a "reasonable investigation."

[B] When a "Reasonable Investigation" Is Required

Under section 11(b)(3)(A), for portions of a registration statement provided on the authority of an "expert," a reasonable ground for belief need not be based on a reasonable investigation. Instead, a non-expert defendant must only show that it had no reasonable ground to believe, and must not have believed, that the expertized statements were untrue or that there were any omissions. Courts have established that it is insufficient for underwriters to blindly rely on the opinions of experts. Although the Securities Act does not require an "investigation" for expertized portions of the registration statements, underwriters remain under a duty to inquire whenever they discover "red flags" in expertised statements.[58]

For all other portions of the registration statement, non-expert defendants must have had, after reasonable investigation, a reasonable ground to believe and a belief in fact that the statements made in the registration statement at the time it became effective were true and that there were no material omissions of facts required to make the statements made in the registration statement not misleading. Courts have held that the receipt of a "comfort letter" from the company's independent public accountants does not in and of itself constitute a reasonable investigation of unaudited financial statements.[59]

[C] The Legal Standard for "Reasonable Investigation"

When a reasonable investigation is required, the defendants must have made a "reasonable attempt" to independently verify the information provided to them by the company and in the offering

58. *In re* WorldCom, Inc. Sec. Litig., 308 F. Supp. 2d 214 (S.D.N.Y. 2004).
59. *See id.*

documents. The extent of such verification is "a matter of judgment in each case."[60] Courts have held that a reasonable investigation is required to assert a due diligence defense, even if it is found that the fraud would not have been discovered with reasonable investigation.[61]

Section 11(c) defines the standard of reasonableness underlying the requirements for a reasonable investigation and a reasonable belief as that required of "a prudent man in the management of his own property." Specifically, Rule 176 under the Securities Act sets forth relevant circumstances in considering whether or not the standard of reasonableness has been met. These include:

- the type of issuer;
- the type of security;
- the type of person;
- the office held when the person is an officer;
- the presence or absence of another relationship to the issuer when the person is a director or proposed director;
- reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts;
- when the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant; and
- whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

§ 49:4 Volcker Rule

The Volcker Rule was enacted in 2010 as part of the Dodd-Frank Act. It is set forth as section 13 of the Bank Holding Company Act of 1956.[62] Five federal regulatory agencies are responsible for administering the Volcker Rule, and these agencies issued regulations (the "VR Regulation") in December 2013 to implement the Volcker Rule.[63]

In general, the Volcker Rule broadly prohibits banking entities from engaging in proprietary trading and from making investments in, and

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60. Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).
61. *See In re* WorldCom, Inc., 308 F. Supp. 2d 214 (2004).
62. 12 U.S.C. § 1851.
63. 79 Fed. Reg. 5536 (Jan. 31, 2014).

having certain other relationships with, certain private investment funds, in each case subject to various exemptions, exceptions, conditions, and requirements.

Under the VR Regulation, "banking entities" are broadly defined to include (1) any insured depository institution; (2) any company that controls an insured depository institution; (3) any bank headquartered outside the United States that is treated as a bank holding company under the International Banking Act of 1978 (that is, because it operates a branch or agency office in the United States); and (4) any subsidiary or affiliate of any of these entities.

§ 49:4.1 Prohibition on Proprietary Trading

The Volcker Rule prohibits banking entities from engaging in proprietary trading, which is generally defined as purchasing, selling or otherwise acquiring, or disposing of financial instruments as principal for the banking entity's trading account for the purpose of short-term gain. "Financial instruments" generally include securities, derivatives, and futures contracts and options on the same, and generally do not include loans (other than loans that are securities or derivatives), physical commodities, and spot foreign exchange.

A transaction is "for the trading account" of a banking entity if one of several tests is met. In general, the VR Regulation includes a rebuttable presumption that a purchase or sale of a financial instrument is "for the trading account" of a banking entity if the banking entity holds the instrument for fewer than sixty days (although holding a financial instrument for longer than sixty days does not mean that an activity is not proprietary trading). In addition, any purchase or sale by a U.S. securities dealer constitutes proprietary trading to the extent the financial instrument is purchased or sold in connection with activities that require the dealer to be licensed as such. A non-U.S. dealer is presumed to be engaged in proprietary trading (regardless of the holding period) "to the extent that the instrument is purchased or sold in connection with the activities of" the entity's dealer business.

§ 49:4.2 Underwriting Exemption Permitting Principal Trading

There are multiple exemptions to the Volcker Rule's prohibition on proprietary trading, including exemptions for underwriting, market-making, certain hedging activities, and, for foreign banking entities, activities conducted solely outside the United States. Each exemption is subject to numerous limitations and conditions.

The underwriting exemption permits the purchase and sale of securities so long as (i) the banking entity is acting as an underwriter for a distribution of securities and the relevant trading desk's underwriting position is related to such distribution; (ii) the amount of securities in the underwriter's position does not exceed the reasonably expected near-term demands of clients; (iii) the underwriting positions are disposed of within a reasonable time; and (iv) the banking entity establishes various controls, including appropriate trading desk limits and compensation arrangements that are designed not to reward or incentivize prohibited proprietary trading.[64] Examples of activities that may be permissible under the underwriting exemption include:

- stabilization activities;
- establishment of syndicate short positions and aftermarket short covering;
- holding an unsold allotment when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution (and selling such position when it is reasonable to do so); and
- helping the issuer mitigate its risk exposure arising from the distribution of its securities (for example, entering into a call-spread option with an issuer as part of a convertible debt offering to mitigate dilution to existing shareholders).[65]

Certain activities not permitted under the underwriting exemption may nevertheless be permissible under other exemptions, such as the market-making exemption, depending on the particular facts and circumstances involved.

§ 49:4.3 Prohibition on Sponsoring and Investing in Private Funds

The other hallmark provision of the Volcker Rule prohibits a banking entity from acquiring or retaining an ownership interest in, or having certain other relationships or conducting transactions with, certain private funds, referred to as covered funds. Covered funds are generally issuers that would be considered an investment company under the Investment Company Act but for the exemptions under section 3(c)(1) or 3(c)(7) of such act, as well as certain similar foreign private funds and commodity pools. The VR Regulation, however,

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64. *See* 17 C.F.R. § 255.4(a).
65. *See* 79 Fed. Reg. at 5568.

generally permits a banking entity to engage in underwriting and market-making involving ownership interests in covered funds so long as the activity is conducted in compliance with the applicable proprietary trading restrictions on those activities discussed above. In addition, the Volcker Rule Regulation imposes per fund and aggregate quantitative ownership limits on a banking entity's permitted ownership interests in covered funds that the banking entity organizes and offers or engages in underwriting or market-making involving ownership interests thereof, including a 3% limit on the number and amount of ownership interests in any one covered fund organized and offered by a banking entity.

§ 49:4.4 Compliance

The Volcker Rule Regulation generally requires that banking entities establish a compliance program designed to ensure compliance with the Volcker Rule. Banking entities with significant trading assets and liabilities also must comply with detailed reporting and recordkeeping requirements in connection with the restrictions on proprietary trading. Banking entities subject to the Volcker Rule Regulation were required to come into compliance with the Volcker Rule, and thus cease all prohibited proprietary trading and covered fund activities, as of July 21, 2015, although the Board of Governors of the Federal Reserve System ("Federal Reserve") extended the conformance period to July 21, 2017, for certain legacy covered fund ownership interests and relationships established prior to December 31, 2013.[66] As a result of its recent implementation, the Volcker Rule remains a new and complex rule that has not yet been the subject of extensive regulatory guidance or established industry practice.[67]

§ 49:5 Relationship of Investment Banking to Research

§ 49:5.1 Legal Framework

The rules and regulations governing research production and distribution were adopted in part to increase public confidence in the

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66. *See* Federal Reserve Order, dated December 18, 2014.
67. Banking entities that do not establish adequate Volcker Rule compliance programs are subject to formal regulatory enforcement actions. *See* Federal Reserve Order, dated April 20, 2017, imposing a fine of $19.7 million against Deutsche Bank AG for failure to maintain an adequate compliance program. The failures identified by the Federal Reserve included weakness in the methodologies the bank used for demonstrating reasonably expected near-term demands of clients, customer, or counterparties as required for permitted market-making activities as well as weaknesses in the bank's metrics reporting and monitoring process.

integrity of securities research by improving objectivity and transparency, and ensuring the provision of reliable and useful information to investors. The rules and regulations were enacted beginning in the early 2000s following public scrutiny questioning the objectivity of securities research published prior to the bursting of the "dot-com bubble" and the collapse of several large public companies.[68] The rules regulate: research analyst conduct; research analyst compensation; research disclosures; research analyst personal trading; and relationships between research analysts and subject companies, investment banking, sales and trading, and principal trading.

The SRO rules governing research production and distribution have seen significant changes in recent years. In late 2015, as part of the FINRA rulebook consolidation process, the existing NASD and NYSE equity research rules were consolidated into FINRA Rule 2241 (the "Equity Research Rule"). The new rule preserved the vast majority of the substance of the predecessor rules, but also amended them in important ways.[69]

In 2016, FINRA's regulation of research production and distribution was expanded to include fixed-income research for the first time, through FINRA Rule 2242 (the "Fixed-Income Research Rule," and, together with the Equity Research Rule, the "FINRA Research Rules"). The Fixed-Income Research Rule applies many of the concepts of the Equity Research Rule to fixed-income research, but there are

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68. The multiple roles of broker-dealers came under particular regulatory and public scrutiny in the early 2000s following the bursting of the dot-com bubble and the collapse of large, public reporting companies such as Enron and Worldcom. The research departments of various investment banks issued favorable research reports on these and other companies, influenced, it was claimed, by the investment banking department's interest in participating in transactions for the same companies. Various U.S. regulatory bodies and the New York State Attorney General brought actions against ten large broker-dealers alleging in part conflicts of interest around research production. The equity research rules of the NASD and NYSE (now consolidated as FINRA Rule 2241) became effective in 2002, SEC Regulation AC became effective in 2003, the Global Settlement was entered into in 2003, and the Fixed-Income Research Rule became effective in 2016.

69. FINRA Rule 2241 incorporated much of the substance of NASD Rule 2711 and NYSE Rule 472, but restructured some of the existing obligations and added an overarching requirement that firms maintain and enforce policies and procedures that effectively manage conflicts of interest related to research production and distribution. Some of the changes were designed to level the playing field between firms subject to the Global Settlement (discussed below) and those that were not. Other noteworthy changes include changes to the research blackout periods established by the rule.

significant differences between the rules. The chief difference may be that the Fixed-Income Research Rule provides significant exemption from policy-and-procedure and disclosure requirements for firms distributing research to institutional investors only, whereas the Equity Research Rule's obligations apply across-the-board.

The following sections discuss (i) equity and fixed-income research regulations adopted by FINRA, (ii) the Global Settlement, and (iii) SEC Regulation AC.[70]

§ 49:5.2 FINRA Regulation of Research Reports

The Equity Research Rule governs equity research services provided by member firms of FINRA. FINRA's stated objective with respect to the Equity Research Rule is to improve objectivity and independence in research through the following measures:

- restrictions on the relationship between research analysts and investment banking personnel[71] and on communications with companies that are the subject of research;[72]
- restrictions on compensation of research analysts[73] and on personal trading by research analysts;[74]
- prohibitions on promises of favorable research,[75] on retaliation against research analysts for unfavorable research,[76] and on participation in pitches for investment banking business;[77] and
- imposition of quiet periods on the issuance of research reports and public appearances by research analysts.[78]

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70. Section 15(g) of the Exchange Act is also relevant to research. Section 15(g) requires registered broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent misuse of material nonpublic information by broker-dealers or persons associated with them.
71. FINRA Rule 2241(b)(2). *See also* FINRA Rule 5280(b) (requiring member firms to establish, maintain, and enforce policies and procedures reasonably designed to restrict the information flow between research analysts and trading department personnel).
72. FINRA Rule 2241(b)(1)(C).
73. FINRA Rule 2241(b)(2)(E) and (F).
74. FINRA Rule 2241(b)(2)(J).
75. FINRA Rule 2241(b)(2)(K).
76. FINRA Rule 2241(b)(2)(H).
77. FINRA Rule 2241(b)(2)(L).
78. FINRA Rule 2241(b)(2)(I).

Firms that do not produce their own research but merely distribute research reports produced by other firms are subject to a more limited set of policy-and-procedure and disclosure obligations.[79]

The Equity Research Rule also requires the disclosure of conflicts of interest[80] and other information to assist investors in making investment decisions.[81] Member firms must establish written procedures reasonably designed to ensure such firms are in compliance with the FINRA Research Rules.[82]

In 2012, the Equity Research Rule was amended to conform to the requirements of the JOBS Act.[83] The amendments permit research analysts to attend meetings with investment banking personnel for IPOs of EGCs.[84] The amendments also permit publication of research and public appearances during certain quiet periods for IPOs and secondary offerings of EGCs.[85]

The Equity Research Rule also includes certain exemptions from policy-and-procedure requirements for firms with limited investment banking activity.[86]

§ 49:5.3 Fixed-Income Research Rule

The Fixed-Income Research Rule (FINRA Rule 2242) brought into effect FINRA's long-stated ambition to establish a fixed-income research rule.[87] The Fixed-Income Research Rule is modeled on the

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79. FINRA Rule 2241(h). Firms distributing equity research reports produced by affiliates must ensure that a more limited set of disclosures are included in the research report (FINRA Rule 2241(h)(4)), and must establish procedures to ensure that the third-party research report contains no untrue statement of material fact and is otherwise not false or misleading. Firms distributing equity research reports produced by non-affiliated firms may qualify for a full exemption from the rule's requirements if its distribution complies with FINRA Rule 2241(h)(6).
80. FINRA Rule 2241(c)(4).
81. FINRA Rule 2241(c)(2).
82. FINRA Rule 2241(b)(1).
83. *See* FINRA Regulatory Notice 12-49 (Nov. 2012).
84. FINRA Rule 2241 SM .01(b). While research analysts are permitted to attend such meetings, they may not engage in otherwise prohibited conduct, including efforts to solicit investment banking business. *Id*.
85. FINRA Rule 2241(b)(2)(I).
86. *See* NASD FINRA Rule 2711(e); NYSE Rule 472(g)(12241(i).
87. FINRA issued a debt research concept proposal in March 2011 (Regulatory Notice 11-11) and solicited comment on debt research rule proposals in February 2012 (Regulatory Notice 12-09) and October 2012 (Regulatory Notice 12-42). *See also* Shearman & Sterling Client Publication, Thinking Ahead: Breaking Down FINRA's Revised Proposed Fixed-Income Research Rule (Mar. 2013), http://www.shearman.com/en/newsinsights/publica tions/2013/03/thinking-ahead-breaking-down-finras-revised-prop_.

Equity Research Rule, but with some structural changes and other modifications. The most significant difference is that the Fixed-Income Research Rule provides an exemption from many of the policy-and-procedure and all of the particularized disclosure requirements for firms that distribute fixed-income research to institutional investors only, provided that the investors consent to the receipt of such research as required by the rule.[88]

For firms distributing fixed-income research to non-institutional investors, the obligations of the Fixed-Income Research Rule look a lot like the obligations imposed by the Equity Research Rule, with some modifications. These obligations include:

- restrictions on the relationship between research analysts and investment banking, principal trading, and sales and trading personnel,[89] and on communications with companies that are the subject of research;[90]
- restrictions on compensation of research analysts[91] and on personal trading by research analysts;[92]
- prohibitions on promises of favorable research,[93] on retaliation against research analysts for unfavorable research,[94] and on participation in pitches for investment banking business.[95]

Some chief differences between the Equity Research Rule and Fixed-Income Research Rule include that:

- The Fixed-Income Research Rule does not impose any licensing requirements on fixed-income research analysts. Equity research analysts and their supervisors must pass research-specific FINRA licensing examinations.[96]

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88. As further described below, the exemptions cover most of the provisions regarding supervision, coverage determinations, budget and compensation determinations, and all of the particularized disclosure requirements.
89. FINRA Rule 2241(b)(2). *See also* FINRA Rule 5280(b) (requiring member firms to establish, maintain, and enforce policies and procedures reasonably designed to restrict the information flow between research analysts and trading department personnel).
90. FINRA Rule 2241(b)(1)(C).
91. FINRA Rule 2242(b)(2)(E) and (F).
92. FINRA Rule 2242(b)(2)(J).
93. FINRA Rule 2242(b)(2)(K).
94. FINRA Rule 2242(b)(2)(I).
95. FINRA Rule 2242(b)(2)(L).
96. NASD Rule 1050.

- The Fixed-Income Research Rule does not impose quiet periods following the member's participation in the underwriting syndicate of an offering by a subject company.[97]
- The Fixed-Income Research Rule requires the establishment of policies and procedures regarding relationships between research and investment banking and subject companies, but also with the member's sales and trading and principal trading personnel.[98]
- The Fixed-Income Research Rule imposes prohibitions on specific types of communications between trading desk personnel and fixed-income research analysts.[99]

The Fixed-Income Research Rule also includes certain exemptions from policy-and-procedure requirements for firms with limited investment banking activity and limited principal trading activity.[100]

Please see section 49:5.8 below for a chart describing the differences between the Equity Research Rule and Fixed-Income Research Rule.

§ 49:5.4 Fixed-Income Research Rule for Firms Distributing Fixed-Income Research Only to Institutional Investors

FINRA member firms that distribute fixed-income research provided only to certain eligible institutional investors that provide the consent required by the Fixed-Income Research Rule are exempted from certain disclosure and policy-and-procedure requirements of the Fixed-Income Research Rule. Many firms have structured their fixed-income research production to rely on this institutional exemption.

With respect to the consent requirement, for research distribution to investors that qualify as a QIB under Securities Act Rule 144A,[101] firms may rely on a negative consent process.[102] For investors that do

97. For the Equity Research Rule's quiet periods, see FINRA Rule 2241(b)(2)(I).
98. FINRA Rule 2241(b)(1); FINRA Rule 2242(b)(1), (b)(2)(D).
99. FINRA Rule 2242 SM .03.
100. FINRA Rule 2242(h), (i).
101. Any entity that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of unaffiliated issuers qualifies as a Qualified Institutional Buyer. For further discussion, see *infra* section 49:10.2.
102. FINRA Rule 2242(j)(1)(A). The requirements of the negative consent process are that: (1) the FINRA member firm must 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 fixed-income securities; and (2) the QIB must have has affirmatively indicated that it is exercising independent

not qualify as a QIB but do qualify as an institutional account under the definition of FINRA Rule 4512(c) (a $50-million-asset standard), firms must obtain the affirmative consent of the investor to receipt of research that is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for non-institutional investors.[103]

While the Fixed-Income Research Rule does not require institutional fixed-income research to carry the specific disclosures applicable to retail fixed-income research, it does require that such research carry general disclosures (widely referred to as a "health warning") prominently on the first page that:

- the fixed-income research report is intended only for institutional investors and does not carry all of the independence and disclosure standards of retail debt research reports;
- if applicable, that the views in the report may differ from the views offered in retail debt research reports; and,
- 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.[104]

Firms distributing only institutional fixed-income research are also exempt from many of the policy-and-procedure requirements of the rule, as indicated below in Chart 49-1.[105]

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judgment in evaluating the member's recommendations pursuant to FINRA Rule 2111 (generally speaking, this is done through the investor's execution of a standard Rule 2111 certificate), and the FINRA member firm must have provided written disclosure to the QIB that the member may provide fixed-income research reports that are intended for institutional investors and that are not subject to all of the independence and disclosure standards applicable to fixed-income research reports prepared for retail investors.

103. FINRA Rule 2242(j)(1)(B).

104. *See* proposed FINRA Rule 2242(j)(3). With respect to the disclosure requirement, if applicable, that the views in the institutional debt research report may differ from views in retail debt research, FINRA notes institutional debt research is not subject to Supplementary Material .06, which otherwise requires a member to inform its customers of the existence of a different research product offered to other customers that may reach different conclusions or recommendations that could impact the price of the debt security.

105. The chart assumes that the firm does not qualify for the Fixed-Income Research Rule's exemptions for firms with limited investment banking or principal trading activity.

Chart 49-1

Firms Distributing Only Institutional Fixed-Income Research Exemptions from FINRA Rule 2242 Policy-and-Procedure Requirements

Description of Provision (References are to FINRA Rule 2242)	**Applicable to Firms Distributing Retail Research?**	**Applicable to Firms Distributing Only Institutional Research?**
General procedures to manage conflicts: Establish, maintain and enforce policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to fixed-income research. FINRA Rule 2242(b)(1)	Yes	No
Review of reports by investment banking personnel: Prohibit prepublication review, clearance, or approval of fixed-income research reports by investment banking personnel. FINRA Rule 2242(b)(2)(A)(i)	Yes	Yes
Review of reports by principal trading/sales & trading personnel: Prohibit prepublication review, clearance, or approval of fixed-income research reports by principal trading personnel and sales and trading personnel. FINRA Rule 2242(b)(2)(A)(ii), (iii)	Yes	No

Description of Provision (References are to FINRA Rule 2242)	**Applicable to Firms Distributing Retail Research?**	**Applicable to Firms Distributing Only Institutional Research?**
Review of reports by those not directly responsible: Restrict or prohibit prepublication review, clearance or approval of fixed-income research reports by persons not directly responsible for the content of such reports, other than legal and compliance personnel. Subject to exceptions for factual review noted in SM .05. FINRA Rule 2242(b)(2)(B)	Yes	No
Restrict input into coverage decisions: Restrict or limit input by investment banking department, sales and trading and principal trading personnel into fixed-income research coverage decisions to ensure that research management independently makes all final decisions regarding the research coverage plan. FINRA Rule 2242(b)(2)(C)	Yes	No
Supervision/compensation evaluation of analysts: Limit supervision and compensatory evaluation of fixed-income research analyst to persons not engaged in (a) investment banking services transactions and (b) principal or sales and trading activities. FINRA Rule 2242(b)(2)(D)	Yes	No

Description of Provision (References are to FINRA Rule 2242)	**Applicable to Firms Distributing Retail Research?**	**Applicable to Firms Distributing Only Institutional Research?**
Fixed-income budget determinations: Limit determination of fixed-income 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. FINRA Rule 2242(b)(2)(E)	Yes	No
Basis of analyst compensation: Prohibit compensation of fixed-income research analysts based on specific investment banking services or specific trading transactions or contribution to a firm's investment banking services or principal trading activities. FINRA Rule 2242(b)(2)(F)	Yes	No
Committee review of analyst compensation: Require that the compensation of a fixed-income research analyst primarily responsible for the substance of a research report be reviewed by a committee reporting to the board of directors, without any representation from investment banking personnel or persons engaged in principal trading activities. Additional affirmative obligations apply as cited in this section. FINRA Rule 2242(b)(2)(G)	Yes	No

Description of Provision (References are to FINRA Rule 2242)	**Applicable to Firms Distributing Retail Research?**	**Applicable to Firms Distributing Only Institutional Research?**
Policies to insulate analysts from pressure, review, oversight of certain personnel: Establish information barriers or other institutional safeguards to ensure that fixed-income research analysts are insulated from review, pressure, or oversight from persons involved in investment banking, principal trading, sales and trading, and others who might be biased in their judgment and supervision. FINRA Rule 2242(b)(2)(H)	Yes	Yes, with respect to insulation from pressure
Prohibit retaliation: Prohibit retaliation against fixed-income analysts by any employee as the result of an unfavorable research. FINRA Rule 2242(b)(2)(I)	Yes	Yes
Analyst trading: Restrict or limit fixed-income research analyst account trading in securities, any derivatives of such securities, and any fund whose performance is materially dependent upon the performance of securities covered by the fixed-income research analyst. FINRA Rule 2242(b)(2)(J)	Yes	No
Promises of favorable research: Prohibit explicit or implicit promises of favorable fixed-income research, a particular fixed-income research rating or recommendation, or specific fixed-income research content as inducement for the receipt of business or compensation. FINRA Rule 2242(b)(2)(K)	Yes	Yes

Description of Provision (References are to FINRA Rule 2242)	**Applicable to Firms Distributing Retail Research?**	**Applicable to Firms Distributing Only Institutional Research?**
Objectivity of analysts, including prohibition on participating in investment banking pitches and solicitations: Restrict or limit activities by fixed-income research analysts that can reasonably be expected to compromise their objectivity, including prohibiting: (i) participation in pitches and other solicitations of investment banking services transactions; and (ii) participation in road shows and other marketing on behalf of an issuer related to an investment banking services transaction. FINRA Rule 2242(b)(2)(L)	Yes	Yes
Prohibit investment banking direction regarding marketing and communications: Prohibit investment banking department personnel from directly or indirectly: (i) directing a fixed-income research analyst to engage in sales or marketing efforts related to an investment banking services transaction; and	Yes	Yes

Description of Provision (References are to FINRA Rule 2242)	**Applicable to Firms Distributing Retail Research?**	**Applicable to Firms Distributing Only Institutional Research?**
(ii) directing a fixed-income research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction. FINRA Rule 2242(b)(2)(M)		
Review by subject company: Prohibit prepublication review of fixed-income research reports by a subject company (except for fact-checking). FINRA Rule 2242(b)(2)(N)	Yes	Yes
Pitch materials: Prohibition on including in pitch materials any information about fixed-income research capacity that suggest that the firm might provide favorable fixed-income research coverage. This prohibits including analyst ranking. (SM .01)	Yes	No
Restrictions on analyst communications with customers: Prohibition on analyst communication with current or prospective customer in the presence of investment banking personnel or company management. (SM .02(a))	Yes	Yes

Description of Provision (References are to FINRA Rule 2242)	**Applicable to Firms Distributing Retail Research?**	**Applicable to Firms Distributing Only Institutional Research?**
Information Barriers between analysts and trading desk personnel: Requirement for procedures to prohibit (a)(1) principal trading or sales and trading personnel from influencing analysts view to benefit trading position of firm or customers, and (a)(2) analysts identifying or recommending specific transactions to desk personnel inconsistent with published report, or disclosing timing of, or material conclusions in, a pending report. The provision also permits enumerated types of communications. (SM .03)	Yes	No
Selective Dissemination. Prohibition on differentiating a fixed-income research product based on the timing of receipt; nor may a firm label a fixed-income research product with substantially the same content as a different fixed-income research product as a means to allow certain customers to trade in advance of other customers. In addition, a firm that provides different fixed-income research products and services for different customers must provide disclosure. (SM .06)	Yes	No
Joint Due Diligence: Prohibited in the presence of investment banking personnel prior to the awarding of a mandate. (SM .09)	Yes	No

§ 49:5.5 *Global Research Analyst Settlement*

In October 2003, the SEC, the New York Attorney General, and other regulators settled various enforcement actions against a group of major financial institutions (the "Global Settlement") relating to their practices regarding research analysts, research reports, and investment banking personnel. The Global Settlement was most recently amended in March 2010.

The Global Settlement seeks to achieve the separation of research and investment banking functions.[106] In particular, the Global Settlement places restrictions on the ability of investment banking personnel to influence the budget and expenses available to research departments,[107] interact with research personnel,[108] and influence research coverage decisions.[109] The Global Settlement also requires the provision of independent research from at least three providers.[110] Finally, the Global Settlement requires the settling firms to make disclosures regarding conflicts of interest and the availability of third-party research reports.[111]

The Global Settlement is of narrower applicability than the FINRA Research Rules because:

- The Global Settlement is only applicable to the firms that were parties to the settlement agreement.
- The definition of "research report" in the Global Settlement applies to reports that are furnished to investors in the United States.[112]
- The Global Settlement's restrictions and requirements on the separation of research and investment banking apply only for research reports relating to a U.S. company or a non-U.S. company for which a U.S. market is the principal equity trading market.[113]

§ 49:5.6 *Regulation AC*

The SEC's Regulation Analyst Certification ("Regulation AC") requires brokers, dealers, and certain persons associated with a broker

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106. *See* Global Settlement, add. A, sec. I.
107. *See* Global Settlement, add. A, sec. I, ¶ 3.
108. *See* Global Settlement, add. A, sec. I, ¶¶ 4, 10.
109. *See* Global Settlement, add. A, sec. I, ¶ 7.
110. *See* Global Settlement, add. A, sec. III, ¶ 1.
111. Global Settlement, add. A, sec. II, ¶ 1.
112. Global Settlement, add. A, sec. I, ¶ 1(e).
113. Global Settlement, add. A, sec. II, ¶ 3.

or dealer that distribute research reports to include certifications by the research analyst that the views contained in the report accurately reflect the analyst's personal views, and disclose whether or not the analyst received compensation or other payments in connection with the analyst's specific recommendations or views.[114]

Regulation AC also requires broker-dealers to make and keep records related to public appearances by research analysts.[115] These records must include statements by the research analyst attesting that the views expressed by the analyst accurately reflected his or her personal views, and that no part of the analyst's compensation was related to any specific recommendations or views.[116]

Regulation AC applies to both equity and fixed-income research.[117]

SEC Regulation AC enforcement has included an enforcement action against a firm whose analyst signed the Regulation AC certification that the report accurately reflected his personal views, while expressing to the firm's sales-and-trading staff that he wanted to downgrade the subject company, but did not in order to maintain his relationship with company management. The analyst also instructed certain customers to sell the security notwithstanding the published buy rating.[118]

§ 49:5.7 Toys "R" Us Enforcement Actions Regarding Rule 2711

In December 2014, FINRA announced that it had taken enforcement action against ten firms and imposed total fines of over $40 million relating to the interactions of the firms' research analysts with investment banking personnel and a prospective issuer, Toys "R" Us (TRU), in respect of TRU's potential IPO, alleging violations of NASD Rule 2711's prohibitions on analyst participation in efforts to solicit investment banking business and firm promises of favorable research (the "TRU enforcement actions").[119] In May 2015, FINRA published

114. *See* 17 C.F.R. § 242.501(a).
115. 17 C.F.R. § 242.502(b).
116. *Id*.
117. 17 C.F.R. § 242.500 (2012). The definitions of "research report" and "public appearance" do not refer to either equity or fixed-income research.
118. In the Matter of Deutsche Bank Securities Inc., Securities Exchange Act Release No. 79,083 (Oct. 2016).
119. Press Release, FINRA, FINRA Fines 10 Firms a Total of $43.5 Million for Allowing Equity Research Analysts to Solicit Investment Banking Business and for Offering Favorable Research Coverage in Connection with Toys "R" Us IPO (Dec. 11, 2014), http://www.finra.org/newsroom/2014/finra-fines-10-firms-total-435-million.

Research Rules Frequently Asked Questions (the "Research FAQs"), which provides more generalized guidance on FINRA's views on some of the issues raised by the TRU enforcement actions.[120]

Although the facts of each of the TRU enforcement actions varied, FINRA seemed to focus on two aspects of the TRU IPO process in particular: (1) the appearance of analysts at a meeting with the issuer at which the issuer solicited the analysts' views on the company, after a TRU sponsor informed the banks that it would consider the firm's analyst's views in determining whether the firm would receive an underwriting role in the IPO (although some firms' analysts did not discuss specific comparables or TRU valuation metrics based on their compliance and legal team's direction), and (2) the completion by the banking teams of a valuation template, when the TRU sponsor had stated that, if selected, the firm, including the analyst, would be expected to stand behind the valuation provided in the template. The TRU enforcement actions, accordingly, raised questions regarding required policies and procedures with respect to analyst-issuer communications and regarding the completion of valuation templates by banking teams.

The Research FAQs articulate three stages of the IPO process, with a sliding scale of attendant risks for analyst/issuer communications: (1) a pre-IPO period; (2) a solicitation period; and (3) a post-mandate period. FINRA considers the solicitation period to begin when the issuer makes known that it intends to proceed with an IPO and to end when there is a bona fide awarding of an underwriting mandate to a particular bank. In the solicitation period, FINRA views research analyst communications with the issuer as carrying significantly elevated risk, although FINRA expressly states that not all analyst/issuer communications during the solicitation period are violative of the research rules and specifically references "bona fide" due diligence and vetting communications. However, the Research FAQs provide that "[i]n general, FINRA believes that positive statements to an issuer by a research analyst during a solicitation period carry a high risk of constituting an impermissible promise of favorable research," and that in circumstances where an issuer overtly or tacitly expresses that the selection of underwriters will be based in whole or in part on the views of a research analyst (including valuation), FINRA believes any subsequent sharing of those views by the member or the research analyst during the solicitation process would carry unmanageable risk.

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120. For the FAQs, see FINRA, Research Rules Frequently Asked Questions (FAQ), http://www.finra.org/industry/faq-research-rules-frequently-asked-questions-faq (last visited July 6, 2015).

Communications during the pre-IPO and post-mandate periods, as well as communications for follow-on offerings, would carry less risk in FINRA's view, but, again, the Research FAQ's expressly decline to create any periods during which analyst-issuer communications are absolutely prohibited or permitted, instead noting that context and content are highly important in the analysis.[121]

The Research FAQs also provide guidance on the communications between investment banking personnel and research analysts in a vetting context, noting that investment bankers may consult with research analysts regarding analyst views regarding valuation, but banks may not expressly state or let a tacit understanding exist that the bankers' views regarding valuation are aligned with those of the analyst.[122] If an issuer creates an improper expectation that a firm's valuation will reflect a research analyst's view or analyst alignment with the investment bankers' view, a firm that wishes to continue to compete for a role in the offering must repudiate the overture and explain that any valuation provided represents the bankers' views only and that the firm cannot make any representations about the views of the research analyst.

§ 49:5.8 Disclosure Requirements

The FINRA Research Rules require member firms to disclose (i) conflicts of interest, and (ii) information to assist investors in making investment decisions.

The following chart describes and compares the disclosures required under the Equity Research Rule and Fixed-Income Research Rule. As noted in each row in the chart, firms relying on the Fixed-Income Research Rule's institutional research exemption do not need to provide any particularized disclosures, and only need provide the standard "health warning" set out in the rule.

121. *Id.* FAQs 1–3.
122. *Id.* FAQ 4.

Chart 49-2

Equity Research Rule and Fixed-Income Research Rule Comparison of Required Disclosures

Topic	Disclosure	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Analyst	The research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and the nature of the financial interest.	Yes (FINRA Rule 2241(c)(4)(A)).	Yes (FINRA Rule 2242(c)(4)(A)). Not required for firms distributing only institutional fixed-income research.
Ownership of subject company securities	If the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company.	Yes (FINRA Rule 2241(c)(4)(F)).	No, but there is obligation to disclose material conflicts of interest per FINRA Rule 2242(c)(4)(H), and to disclose if the firm trades as principal in the fixed-income securities that are the subject of the report or related derivatives. (FINRA Rule 2242(c)(4)(F)). Not required for firms distributing only institutional fixed-income research.

Topic	Disclosure	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Any material conflict of interest	Any material conflict of interest of the research analyst or member that the research analyst or an associated person of the member with the ability to influence the content of a research report knows or has reason to know at the time of the publication or distribution of a research report.	Yes (FINRA Rule 2241(c)(4)(I)).	Yes (FINRA Rule 2242(c)(4)(H)). Not required for firms distributing only institutional fixed-income research.
Research analyst compensation based on certain firm revenues	If the research analyst has received compensation based upon (among other factors) the member's investment banking revenues.	Yes (FINRA Rule 2241(c)(4)(B)).	Yes and also requires disclosure of analyst compensation based on principal trading or sales and trading (FINRA Rule 2242(c)(4)(B)). Not required for firms distributing only institutional fixed-income research.

Topic	Disclosure	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Investment banking compensation	Firm or affiliate: a. managed or co-managed a public offering of securities for the subject company in the past twelve months; b. received compensation for investment banking services from the subject company in the past twelve months; or c. expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.	Yes (FINRA Rule 2241(c)(4)(C)).	Yes (FINRA Rule 2242(c)(4)(C)). Not required for firms distributing only institutional fixed-income research.

Topic	Disclosure	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Non-investment banking compensation of firm, client of firm, affiliate	If, as of the end of the month immediately preceding the date of publication or distribution of a research report (or the end of the second most recent month if the publication or distribution date is less than thirty 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 twelve months. If the subject company is, or over the twelve-month period preceding the date of publication or distribution of the research report has been, a client of the member, and if so, the types of services provided	Yes (FINRA Rule 2241(c)(4)(D), (E)).	Same as FINRA Rule 2241(2242(c)(4)(D), (E)). Exemptions for firms distributing only institutional fixed-income research.

Topic	Disclosure	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
	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.		
Trading as principal in the fixed-income securities (or related derivatives) that are the subject of the research report	If the member trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the fixed-income research report.	No.	Yes (FINRA Rule 2242(c)(4)(F)). Not required for firms distributing only institutional fixed-income research.
Meaning of ratings	If a research report contains a rating, the firm must define in the research report the meaning of each rating used by the firm in its rating system, including time horizon and any benchmark.	Yes (FINRA Rule 2241(c)(2)).	Yes (FINRA Rule 2242(c)(2)). Not required for firms distributing only institutional fixed-income research.

Topic	Disclosure	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Distribution of ratings	A firm must disclose in each research report the percentage of all securities rated by the firm to which the firm would assign a "buy," "hold/neutral," or "sell" rating. In each research report, the firm must disclose the percentage of subject companies within each of these three categories for whom the firm has provided investment banking services within the previous twelve months.	Yes (FINRA Rule 2241(c)(2)(A)).	Yes, except that the disclosure requires the percentage of all subject companies (rather than securities) to which the firm has assigned the particular rating (FINRA Rule 2242(c)(2)(A)). Not required for firms distributing only institutional fixed-income research.
Price Chart	If a research report contains either a rating or a price target, and the firm has assigned a rating or price target to the subject company's securities rating for at least one year, the research report must include a line graph of the security's daily	Same as FINRA Rule 2711 (FINRA Rule 2241(c)(3)).	Yes, except that there is no reference to a price target and, accordingly, no requirement to have a line graph of the security's daily closing prices. Instead, there must be disclosure of each date on

Topic	Disclosure	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
	closing prices for the period that the firm has assigned any rating or price target or for a three-year period, whichever is shorter.		which the firm assigned the rating and the rating assigned (FINRA Rule 2242(c)(3)). Not required for firms distributing only institutional fixed-income research.
Price targets and ratings	Any recommendation, rating, or price target 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, rating, or price target.	Yes (FINRA Rule 2241(c)(1)(B)).	Same as FINRA Rule 2241, except that reference to price targets is eliminated (FINRA Rule 2242(c)(1)(B)). Not required for firms distributing only institutional fixed-income research.
Market making	If firm was making a market in the subject company's securities at the time that the research report was published.	Yes (FINRA Rule 2241(c)(4)(G)).	No

Topic	Disclosure	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Exemptions for certain disclosures that would disclose MNPI	A member or research analyst will not be required to make a disclosure required by paragraph (c)(4) to the extent such disclosure would reveal material nonpublic information regarding specific potential future investment banking transactions.	Yes (FINRA Rule 2241(c)(5)).	Yes (FINRA Rule 2242(c)(5)).

Unlike the FINRA Research Rules, the Global Settlement only requires generic disclosures regarding potential conflicts of interest.[123] While the Global Settlement does not require the disclosure of any information to assist investors in making investment decisions, it does require the settling firms to provide independent research from at least three providers.[124]

§ 49:5.9 *Firewalls and Chaperoning*

Firewalls are the policies and practices that are implemented to restrict the transmission of MNPI or limit conflicts of interest of a financial institution. In the context of research and investment banking, firewalls refer to the restrictions on interaction between research and personnel outside the research department.

The FINRA Research Rules generally permit communications between research and non-research personnel that are not expressly prohibited,[125] but do require the establishment of information barriers to ensure that research analysts are insulated from review, pressure, or oversight of investment banking personnel (and, in the Fixed-Income

123. Global Settlement, add. A, sec. II, ¶ 1.
124. Global Settlement, add. A, sec. III, ¶ 1.
125. *See* JOINT REPORT BY NASD AND THE NYSE ON THE OPERATION AND EFFECTIVENESS OF THE RESEARCH ANALYST CONFLICT OF INTEREST RULES (Dec. 2005) [hereinafter JOINT REPORT BY NASD AND THE NYSE], at 9.

Research Rule, sales and trading and principal trading personnel) and are not subject to retaliation as a result of an unfavorable research report. In addition, firms must be mindful to ensure that investment banking personnel do not direct research personnel to engage in communications with subject companies or investors.[126] Investment banking personnel and other employees who are not directly responsible for investment research are generally prohibited from reviewing research reports before publication.[127] Non-investment banking personnel, however, are permitted to review equity research reports prior to publication to the extent necessary to verify the factual information in the report, and, in the case of fixed-income research, personnel other than investment banking, principal trading, and sales and trading personnel are permitted to do the same.[128]

Application of information barriers required by the Fixed-Income Research Rule represents a cultural shift, as firms often employ individuals to provide analytical support for fixed-income trading desks, and those brief analyses (termed "trader commentary," "trade ideas," or "desk commentary") were sometimes distributed externally. Under the Bond Market Association's Guiding Principles,[129] those types of written analyses were excluded from the definition of fixed-income research report and the policy-and-procedure requirements of the Guiding Principles were therefore not applicable to those analyses. The Fixed-Income Research Rule, however, has no such specific exclusion for trader commentaries, and given the breadth of the rule's definition of "debt research report,"[130] some trader commentaries could be viewed as triggering regulation under the Fixed-Income Research Rule. Although the Fixed-Income Research Rule exempts firms distributing only institutional research from many of its policy-and-procedure requirements, even such firms are required to establish information barriers to insulate fixed-income research analysts from pressure from persons engaged in principal trading or sales and trading. Some have interpreted that obligation to mean that personnel

126. FINRA Rule 2241(b)(2)(M); FINRA Rule 2242(b)(2)(M).
127. FINRA Rule 2241(b)(2)(A); FINRA Rule 2242(b)(2)(A).
128. FINRA Rule 2241 SM .05; FINRA Rule 2242 SM .05.
129. SIFMA, Guiding Principles to Promote the Integrity of Fixed Income Research (May 2004). The Guiding Principles were a collaboration of member firms of the Bond Market Association to enhance investor protection by establishing an industry-standard approach to issues around fixed-income research, including conflicts of interest. Adherence to the Guiding Principles was voluntary.
130. The rule defines a debt research report as "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," subject to certain exclusions. FINRA Rule 2242(a)(3).

generating such commentaries could not continue to sit on the trading desk. Although FINRA has expressed a view that at least some trader commentaries should not be viewed as fixed-income research reports, it has acknowledged the conundrum faced by the industry. In May 2017, FINRA requested comment on a limited safe harbor for both fixed-income and equity desk commentaries that would subject the same to lighter-touch regulation under the relevant rules.[131]

The firewall requirements in the Global Settlement are more restrictive and generally prohibit all communications between research analysts and investment banking personnel, unless such communications are expressly permitted.[132] Research analysts and investment banking personnel must be physically separated to prevent flow of information between the two.[133] In addition, firewalls must be designed to reasonably prohibit communications between research and investment banking personnel relating to investment banking or research activities.[134] The Global Settlement permits communications between research analysts and non-research personnel in certain limited circumstances:

- Investment banking personnel may seek views of research analysts on the merits of a proposed transaction, a potential candidate for a transaction, or market or industry trends (referred to as vetting calls).[135] Research analysts can seek information regarding market or industry conditions, provided that such communications are consistent with those an analyst might have with investing customers (referred to as industry calls).[136] All such communications must be made in the presence of a chaperone.[137]

- Research analysts and investment banking personnel can participate together in commitment committee discussions, provided that the research analysts have an opportunity to express their views outside the presence of investment banking personnel.[138]

131. FINRA Regulatory Notice 17-16 (Apr. 2017), https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-16.pdf.
132. *See* JOINT REPORT BY NASD AND THE NYSE, *supra* note 125, at 9.
133. Global Settlement, add. A, sec. I, ¶ 4.
134. *See* Global Settlement, add. A, sec. I, ¶ 10. *See also* Global Settlement, add. A, sec. I, ¶ 10(g) (permitting without restriction communications between research analysts and investment banking personnel that are not related to investment banking or research activities).
135. *See* Global Settlement, add. A, sec. I, ¶ 10(a).
136. *Id.*
137. *Id.*
138. *See* Global Settlement, add. A, sec. I, ¶ 10(b).

- Research analysts may assist in confirming the adequacy of disclosures for a transaction based on their communications with the company and other third parties.[139] Chaperones must be present if such communications between the research analyst and the company or third parties are later disclosed to investment banking personnel.[140]

- Research analysts may also conduct "joint due diligence" with investment banking personnel.[141]

- Research analysts can assist the equity capital markets group with the pricing and structuring of transactions when the financial institution receives an investment banking mandate or a request for the submission of a transaction proposal.[142]

- When the financial institution receives an investment banking mandate or a request for the submission of a transaction proposal, research analysts can assist with the education of the firm's sales force regarding the transaction.[143] However, research personnel may not appear jointly with investment banking personnel or the issuer's management during such communications with the sales force.[144] The contents of communications by research analysts must have a reasonable basis, and be fair and balanced, that is, "fair and balanced," as generally understood under FINRA Rule 2210(d)(1) and after taking into consideration the overall context in which such communications are made.[145]

- Research analysts can attend or participate in widely attended conferences or events that are also attended by investment banking personnel or in which investment banking personnel participate.[146]

- Research analysts and investment banking personnel can also attend or participate in firm meetings at which matters of general firm interest are discussed.[147] They may communicate with each other with respect to legal or compliance issues, provided that chaperones are present.[148]

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139. *See* Global Settlement, add. A, sec. I, ¶ 10(c).
140. *See* Global Settlement, add. A, sec. I, ¶ 10(c)(ii).
141. See Global Settlement, add. A, sec. I, ¶ 10(c)(i).
142. *See* Global Settlement, add. A, sec. I, ¶ 10(d)(i)–(ii).
143. *See* Global Settlement, add. A, sec. I, ¶ 10(d)(iii).
144. *Id.*
145. *Id.*
146. *See* Global Settlement, add. A, sec. I, ¶ 10(e).
147. *See* Global Settlement, add. A, sec. I, ¶ 10(f).
148. *Id.*

Firms subject to the Global Settlement, therefore, are required to have teams of compliance chaperones to attend calls between investment banking and research personnel and review and approve electronic communications between them.

Maintenance of information barriers for firms with research operations is critical to ensure not only compliance with the FINRA Research Rules' provisions regarding conflicts of interest, but also to ensure that MNPI is not leaked from the research department. One research FINRA enforcement action was directed against a firm for not taking sufficient measures to restrict access to equity research department "hoots" that contained MNPI regarding upcoming research reports.[149]

§ 49:5.10 Joint Due Diligence

Despite the restrictions described above on the relationship between investment banking and research, the FINRA Research Rules and the Global Settlement permit research analysts and investment banking personnel to conduct due diligence jointly. Under the Global Settlement, joint due diligence is permitted only if the following conditions are met:[150]

- the session must be for the limited purpose of gathering or confirming information about the company or the proposed transaction;
- the firm must have received an investment banking mandate or a request for the submission of a transaction proposal in connection with a block bid or competitive follow-on offering; and
- chaperones must be present during such joint due diligence sessions. If the joint due diligence session is in connection with a request for a transaction proposal, joint diligence sessions are permitted only if the firm's legal or compliance staff reasonably believes that there will not be a meaningful opportunity to conduct separate due diligence prior to the award of a mandate.

The FINRA Research Rules prohibit joint due diligence prior to the selection of underwriters, except in the case of Emerging Growth Companies if such prohibition is contrary to the JOBS Act.[151]

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149. *See* Deutsche Bank Securities, Inc., Letter of Acceptance, Waiver, and Consent (Aug. 2016).
150. *See* Global Settlement, add. A, sec. I, ¶ 10(c)(i).
151. FINRA Rule 2241 SM .02; FINRA Rule 2242 SM .09; FINRA Regulatory Notice 15-30.

§ 49:5.11 *Further Separation of Research Analysts from Banking Personnel*

Both the FINRA Research Rules and the Global Settlement place additional restrictions in order to ensure the independence of research analysts from non-research personnel. These additional restrictions are described in Chart 49-3 below.

Chart 49-3

FINRA Research Rules and the Global Settlement Additional Restrictions

Topic	Restriction	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Supervision by non-research personnel	No research analyst may be subject to the supervision or control of any employee of the firm's investment banking department.	Yes (2241(b)(2)(C)).	Policies and procedures must limit supervision to persons not engaged in investment banking services transactions, principal trading activities, or sales and trading (FINRA Rule 2242(b)(2)(D)). Not required for firms distributing only institutional fixed-income research.

Topic	Restriction	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Investment banking personnel directions regarding marketing	Investment banking personnel may not direct analyst to engage in sales or marketing efforts relating to investment banking services transactions, or to communicate with current or prospective customer regarding investment banking services transactions.	Yes (FINRA Rule 2241(b)(2)(M)).	Yes (FINRA Rule 2242(b)(2)(M)).
Prohibition on basing analyst compensation upon certain factors	Prohibit compensation based upon specific investment banking services transactions or contributions to a member's investment banking services activities.	Yes (FINRA Rule 2241(b)(2)(E)).	Yes, and prohibition expanded to include compensation on the basis of specific trading transactions or contributions to trading activities (FINRA Rule 2242(b)(2)(F)). Not required for firms distributing only institutional fixed-income research.

Topic	Restriction	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
Prohibition on influence over/input into analyst compensation by non-research personnel	No personnel engaged in investment banking activities may have any influence or control over the compensatory evaluation of a research analyst.	Yes (FINRA Rule 2241(b)(2)(C)).	Similar to 2241, but instead of referencing influence or control, precludes "input into the compensation of debt research analysts." That prohibition is expanded to include persons engaged in principal trading activities (FINRA Rule 2242(b)(2)(D)). Not required for firms distributing only institutional fixed-income research.
Analyst compensation	Compensation of a research analyst must be reviewed and approved at least annually by a committee that reports to the firm's board of directors. This committee may not have	Yes (FINRA Rule 2241(b)(2)(F)).	Same as 2241, except participation of principal trading personnel is also prohibited, the committee does not need to consider

Topic	Restriction	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
	representation from the firm's investment banking department. The committee must consider the following factors: (A) individual performance, including the analyst's productivity and the quality of the analyst's research; (B) the correlation between the research analyst's recommendations and the stock price performance; and (C) the overall ratings received from clients, sales force, peers independent of the firm's investment banking department and other independent ratings services.		correlation between the analyst's recommendations and the performance of the recommended securities, and no requirement to consider ratings from sales force. Sales and trading personnel expressly permitted to provide input to fixed-income research management in order to convey customer feedback (FINRA Rule 2242(b)(2)(G)). Not required for firms distributing only institutional fixed-income research.

Topic	Restriction	Required by Equity Research Rule?	Required by Fixed-Income Research Rule?
	The committee may not consider as a factor in reviewing and approving such a research analyst's compensation his or her contributions to the firm's investment banking business.		
Research department budget determined by senior manage-ment	Limit determination of the research department budget to senior management, excluding senior management engaged in investment banking services activities.	Yes (FINRA Rule 2241(b)(2)(D)).	Same as FINRA Rule 2241, except that also excludes senior management engaged in principal trading activities. Expressly permits revenues and results of the firm as a whole to be considered, and expressly permits input from any personnel to senior management regarding demand for fixed-income research including product trends and customer

Topic	**Restriction**	**Required by Equity Research Rule?**	**Required by Fixed-Income Research Rule?**
			research interests (FINRA Rule 2242(b)(2)(E)). Not required for firms distributing only institutional fixed-income research.
Prohibition on retaliation against analysts	Prohibit direct or indirect retaliation or threat of retaliation against research analysts employed by the member or its affiliates by persons engaged in investment banking services activities or other employees as the result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the member's present or prospective business interests.	Yes (FINRA Rule 2241(b)(2)(H)).	Yes (FINRA Rule 2242(b)(2)(I)).

§ 49:5.12 Road Shows and Investor Education

The FINRA Research Rules prohibit research analysts from participating in road shows relating to investment banking transactions.[152] They also prohibit research analysts from communicating with customers about such transactions in the presence of investment banking personnel or company management.[153]

The Global Settlement permits research analysts to communicate with investors regarding public offerings of securities, provided the firm has received an investment banking mandate.[154] However, research analysts may not appear jointly with investment banking personnel or issuer's management when making such communications.[155]

The Global Settlement requires that oral communications that express a recommendation or view regarding the offering must have a reasonable basis.[156] Additionally, oral communications that are made to a group of ten or more investors must be "fair and balanced," as generally understood under FINRA Rule 2210(d)(1) and after taking into consideration the overall context in which such communications are made.[157]

Also common in the industry are "investor education" presentations, where a research analyst will meet with institutional investors to discuss an industry sector or a company, sometimes even with company management present. Such meetings must be carefully screened to ensure that they do not either constitute an offer of securities in connection with a forthcoming transaction or a violation of Regulation F-D by the issuer.

§ 49:5.13 Publication of Research During Securities Offerings

The Equity Research Rule imposes "quiet periods," during which a firm is restricted from publishing research reports and making public appearances regarding a subject company.[158] The quiet period restrictions are:

- Firms that have acted as underwriters or dealers in IPOs may not publish a research report or make a public appearance

152. *See* NASD Rule 2711(c)(5)(A); NYSE Rule 472(b)(6)(i)(a).
153. *See* NASD Rule 2711(c)(5)(B); NYSE Rule 472(b)(6)(i).
154. *See* Global Settlement, add. A, sec. I, ¶ 11(a).
155. *See id.*
156. *See* Global Settlement, add. A, sec. I, ¶ 11(a)(1).
157. *See* Global Settlement, add. A, sec. I, ¶ 11(a)(2).
158. *See* FINRA Rule 2241(b)(2)(I).

regarding the subject company for ten calendar days following the date of the offering.[159]

- For secondary offerings, firms that have acted as managers or co-managers may not publish a research report or make a public appearance regarding the subject company for three calendar days following the date of the offering.[160]

The quiet period restrictions are not applicable for the following:

- Research reports and public appearances relating to significant news or events that occur within the applicable quiet period.[161]
- Research reports and public appearances made pursuant to SEC Rule 139 regarding subject companies with "actively traded securities."[162]

§ 49:6 Compensation Structures

§ 49:6.1 FED/SEC Guidance

Broker-dealer compensation structures are also subject to disclosure in public filings pursuant to Regulation S-K. Item 402(s) of Regulation S-K requires the discussion of the relationship between compensation policies and practices for all employees, including non-executive officers, as they relate to risk-management practices and risk-taking incentives. This discussion is required with respect to compensation policies and practices that create risks that are reasonably likely to have a material adverse effect on the company.[163] Discussion must be presented separately from the Compensation Discussion and Analysis disclosures,

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159. *See* FINRA Rule 2241(b)(2)(I)(i). Although the quiet period required by the Equity Research Rule is ten calendar days, many syndicates have chosen to maintain a twenty-five-day quiet period in consideration of certain prospectus rules.
160. *See* FINRA Rule 2241(b)(2)(I)(ii).
161. *See* FINRA Rule 2241(b)(2)(I)(iii). In such circumstances, the research report or the public appearance must be pre-authorized by legal or compliance personnel. *Id*.
162. *Id.* SEC Rule 139 permits the publication and distribution of issuer-specific research reports and industry reports, and deems them to not constitute offers for the sale of securities if certain requirements relating to the subject companies are satisfied. *See* 17 C.F.R. § 230.139. In addition, Regulation M defines actively traded securities as securities having an average daily trading value of $1 million, and that are issued by companies having common equity securities having a public float value of at least $150 million. 17 C.F.R. § 232.101(c)(1).
163. *See* 17 C.F.R. § 229.402(s). The "reasonably likely" threshold is the same as that used in the SEC's rules for the Management's Discussion and Analysis. *See* SEC Implementing Release No. 33-9089, at 12–13 (Feb. 28, 2010).

which relate to a company's compensation program for named executive officers.[164]

Item 402(s) provides some illustrative examples of situations that may trigger this disclosure requirement, such as:

- compensation policies and practices at a business unit that carries a significant portion of the company's risk profile;
- compensation policies and practices at a business unit with compensation structured significantly differently than other units;
- compensation policies and practices at a business unit that is significantly more profitable than others;
- compensation policies and practices at a business unit where compensation expense is a significant percentage of the unit's revenues;
- compensation policies and practices that vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

Item 402(s) also provides illustrative examples of issues that must be addressed in the disclosure, such as:

- general design philosophy of compensation policies and practices for employees whose behavior would be most affected, as such policies and practices relate to or affect risk-taking, and the manner of their implementation;
- risk assessment or incentive considerations in structuring compensation policies and practices or in awarding and paying compensation;
- how the compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short-term and the long-term, such as through policies requiring clawbacks or imposing holding periods;
- policies regarding adjustments to compensation policies and practices to address changes in the company's risk profile, as well as material adjustments that have been made as a result of changes in the company's risk profile; and

164. *See* SEC Implementing Release No. 33-9089, at 13 (Feb. 28, 2010).

- monitoring of compensation policies and practices to determine whether risk management objectives are being met with respect to incentivizing its employees.

The Federal Reserve System's ("Federal Reserve") *Commercial Bank Examination Manual* provides guidance on sound incentive compensation policies.[165]

The Federal Reserve's guidance applies to incentive compensation arrangements for (i) senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines; (ii) individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and (iii) groups of employees who are subject to the same or similar compensation policies and procedures and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk.[166]

Three principles govern incentive compensation arrangements at banking organizations: (i) provision of incentives that appropriately balance risks and rewards in a manner that does not encourage imprudent risk-taking; (ii) creation of effective controls and risk-management processes that reinforce and support the development and maintenance of balanced incentive compensation arrangements; and (iii) strong corporate governance, including active and effective oversight of incentive compensation arrangements by the organization's board of directors.[167]

The Federal Reserve's guidance does not mandate or prohibit any particular forms of compensation policies or procedures. Instead, incentive compensation arrangements are expected to reflect the principles discussed above in a manner tailored to the business, risk profile, and other attributes of the banking organization.[168] However, large banking organizations (LBOs) are recommended to implement and adhere to systematic and formalized policies, procedures, and processes.[169] Smaller banking organizations may have less extensive, formalized, and detailed policies, procedures, and processes.[170]

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165. *See* COMMERCIAL BANK EXAMINATION MANUAL, sec. 4008.1, *Sound Incentive Compensation Policies*.
166. *Id*. at 3.
167. *Id*. at 4, 9, 11.
168. *See* Guidance on Sound Incentive Compensation Policies, Federal Reserve System Docket No. OP-1374, at 21 (June 21, 2010).
169. *See* COMMERCIAL BANK EXAMINATION MANUAL, sec. 4008.1, *Sound Incentive Compensation Policies*, at 2.
170. *Id*. at 3.

The Guidance also notes that federal supervisory agencies may take enforcement action if a banking organization's incentive compensation arrangements or risk management, control or governance processes pose a risk to the organization's safety and soundness.[171]

In June 2016, the Federal Reserve, FDIC, OCC, OTS, the Federal Housing Finance Agency, the National Credit Union, and the SEC published for comment revised proposed rules to implement section 956 of the Dodd-Frank Act.[172] The re-proposed rule prohibits incentive-based compensation arrangements that encourage inappropriate risks by providing compensation that is excessive or that could lead to natural financial loss. The re-proposed rule also requires covered financial institutions to implement policies with respect to incentive-based compensation arrangements and to submit reports regarding the same to federal supervisory agencies. The re-proposed rule would be applicable to covered financial institutions with average total consolidated assets of over $1 billion, with progressively more rigorous requirements applicable to covered institutions with average total consolidated assets of $50 billion and $250 billion.

On April 16, 2013, the European Union (EU) Parliament approved a series of financial reforms, including a cap on bankers' bonuses.[173] The reform limits the basic salary-to-bonus ratio to 1:1.[174] This ratio can be increased to up to 1:2 with shareholder approval.[175] In addition, at least 25% of any bonus exceeding 100% of salary must be deferred for at least five years.[176] The scope of these restrictions has been the subject of continued controversy, particularly in the United Kingdom.

§ 49:6.2 FINRA Corporate Financing Rules

[A] General Overview and Policy Background

FINRA Rule 5110, otherwise known as the Corporate Financing Rule, is the principal rule regulating compensation to underwriters and other FINRA-member participants in public offerings of securities.

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171. *Id*. at 3.
172. Incentive-Based Compensation Arrangements, A Proposed Rule by the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Federal Housing Finance Agency, and the Securities and Exchange Commission, 81 Fed. Reg. 37,670 (June 10, 2016).
173. *See* Press Release, European Parliament, Parliament Votes Reform Package to Strengthen EU Banks (Apr. 16, 2013), http://www.europarl.europa.eu/news/en/news-room/content/20130416IPR07333/html/Parliament-votes-reform-package-to-strengthen-EU-banks.
174. *Id*.
175. *Id*.
176. *Id*.

As a general matter, the Corporate Financing Rule prohibits FINRA members from participating in any public offering in which the underwriting compensation is "unfair or unreasonable."[177]

The restrictions of Rule 5110 apply to FINRA members and persons associated with a FINRA member who "participate in any manner" in a public offering of securities subject to the Corporate Financing Rules. Traditionally, "participation" in the offering has been understood expansively, but in May 2014, the SEC approved amendments to Rule 5110 that specifically exclude from Rule 5110's coverage an independent financial adviser that provides advisory or consulting services to the issuer.

[B] Operation of the Corporate Financing Rules

The Corporate Financing Rule regulates compensation in three ways: (i) by aggregating all "items of value" received by underwriters and other related persons in connection with the public offering and deeming such items of value to be compensation in connection with the public offering; (ii) placing a prohibition on the receipt of certain items of value in connection with participation in a public offering; and (iii) requiring disclosure of all items of value that are deemed to be compensation to the underwriters in connection with the public offering.

Generally, the total demand value of all items of underwriters' compensation may not exceed a certain "reasonable" amount, which many believe to be approximately 9% in larger IPOs and approximately 8% in most other offerings. FINRA has not published the compensation limits.

[C] Items of Value That Are Per Se Unreasonable

FINRA has provided guidance as to certain items of value that are per se unreasonable:[178]

- Reimbursement of underwriter salaries, overhead, or supplies;
- Reimbursement of expenses other than out-of-pocket expenses;
- Certain warrants or options given to underwriters or related persons;
- Receipt of "indeterminate" compensation;
- Overallotment options in excess of 15%; and
- "Tail fees" and rights of first refusal (ROFRs) that do not comply with the requirements described below.

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177. FINRA Rule 5110(c).
178. FINRA Rule 5110(f)(2).

The SEC has clarified the circumstances under which termination fees and ROFRs are permitted. Previously, both tail fees and ROFRs were considered "per se unreasonable" items of value except in very limited situations.

Under FINRA Rule 5110(f)(2)(D)(ii), termination fees or "tail" fees are now permitted where:

- the agreement between the participating member and the issuer specifies that the issuer has a right of "termination for cause";
- the issuer's exercise of its right of "termination for cause" eliminates any obligations of the issuer with respect to the payment of any termination fee;
- the amount of any specified termination fee is reasonable in relation to the services contemplated in the written agreement;
- the issuer is not responsible for paying the termination fee unless an offering or other type of transaction is consummated by the issuer (without involvement of the FINRA member) within two years of the date the issuer terminates the engagement with the participating member.

Note that in order for tail fees and ROFRs to be permissible items of value, any engagement letters entered into between the participating member and the issuer must specifically set out the conditions set out above, in particular the specific termination rights of the issuer. FINRA may require any engagement letter that does not meet these conditions to be amended.

Similarly, FINRA re-evaluated its position with respect to ROFRs granted in offerings that are not completed, and has permitted participating members to retain ROFRs to participate in future transactions even if the public offering in which the ROFR was granted is not so consummated. Specifically, under FINRA Rule 5110(f)(2)(D)(ii), such continuing ROFRs are permitted where:

- The agreement between the participating member and issuer specifies that the issuer has a right of termination for cause;
- The issuer's exercise of its right of termination for cause eliminates any obligation of the issuer with respect to the provision of any ROFR; and
- Any fees arising from services provided under a ROFR are customary for those types of services.

In addition, FINRA Rule 5110(f)(2)(E) continues to provide that the duration of any ROFR must not be in excess of three years from

(i) the date of commencement of sales in the public offering or (ii) the date the issuer terminates the engagement. In either case, the agreement may not provide for more than one opportunity to waive or terminate the ROFR in consideration of any payment or fee.

[D] Defining "Compensation"

Compensation under the Corporate Financing Rule is stated broadly in Rule 5110(c)(2)(B) as "all items of value received or to be received from any source by the underwriter and related persons which are deemed to be in connection with or related to the distribution of the public offering [. . .].

If an underwriter or related person receives an "item of value" from the issuer during the 180-day period preceding the filing of a registration statement or a prospectus supplement, it will be deemed to be compensation.

[E] Items of Value

The term "items of value" is broadly defined in Rule 5110(c)(3) and includes (without limitation):

(i) The underwriter's discount or commission;

(ii) Securities received for providing certain services in connection with an investment in unregistered securities;

(iii) Reimbursement of expenses to or on behalf of the underwriter and related persons;

(iv) Fees and expenses of underwriter's counsel (except for reimbursement of "blue sky" fees);

(v) Finder's fees, whether in the form of cash, securities, or any other item of value;

(vi) Fees paid to Qualified Independent Underwriters (QIUs);

(vii) Rights of first refusal; and

(viii) Special sales incentive items.

The following are not "items of value":

(i) Cash compensation for providing services in connection with a (i) private placement; (ii) loan or credit facility; or (iii) merger or acquisition.

(ii) Certain expenses that are normally paid by the issuer (for example, "blue sky" fees, FINRA filing fees, and printing costs). Reimbursement of underwriter's counsel fees are not included within this exception.

(iii) Securities listed on U.S. and designated offshore securities markets that are purchased "in a public market transaction."

(iv) Non-convertible or non-exchangeable debt securities and derivative instruments will not be considered items of value if such securities were acquired:

i. For a fair price;

ii. In the ordinary course of business; and

iii. In transactions unrelated to the public offering.

[F] Conflicts of Interest

An offering is subject to FINRA Rule 5121 when a "conflict of interest," as defined, exists. That rule prohibits a member that has a conflict of interest from participating in a public offering unless the offering complies with the requirements of Rule 5121. A conflict of interest exists if:

- the securities are to be issued by the member;
- the issuer controls, is controlled by or is under common control with the member or the member's associated persons;
- at least 5% of the net offering proceeds, not including underwriting compensation, are intended to:
  - reduce or retire a credit facility extended by the member or its affiliates; or
    - a typical "conflict of interest" under Rule 5121 is the repayment of indebtedness to a lender that is a related person of one of the underwriters. A downsizing of the offering may trigger the application of Rule 5121 if the reduction in the total amount of proceeds causes the amount of proceeds directed to the underwriter-related lender to exceed the 5% threshold under this rule.
  - be otherwise directed to the member or its affiliates; or
    - under the rule, the receipt of 5% or more of the net offering proceeds by *any individual underwriter* or its affiliate can give rise to a "conflict of interest";
- as a result of the public offering and any transactions contemplated at the time of the public offering, the member will:
  - be an affiliate of the issuer;
  - become publicly owned; or

- the issuer will become a member or form a broker-dealer subsidiary.

[F][1] Definition of "Affiliate"

Rule 5121 defines "affiliate" to mean an entity that controls, is controlled by, or is under common control with a member. "Control" is defined as:

- Beneficial (economic) ownership of 10% or more of an entity's outstanding equity or debt including, in each case, any right to receive such securities within sixty days of the member's participation in the public offering;
- The right to 10% or more of the distributable profits or losses of an entity that is a partnership, including the right to receive an interest in such distributable profits or losses within sixty days of the member's participation in the public offering; or
- The power to direct or cause the direction of the management or policies of an entity.

[F][2] Compliance in the Event of a Conflict of Interest

If there is a conflict of interest under Rule 5121, then a broker-dealer may not participate in the public offering unless the offering complies with Rule 5121(a)(1) or 5121(a)(2).

Rule 5121(a)(1) mandates that prominent disclosure is made regarding the nature of the conflict. For offering documents that are subject to SEC regulation S-K, "prominent disclosure" requires including a separate notation (to be called "Conflict of Interest") that is placed in the Table of Contents of the Registration Statement, the Summary, and the Plan of Distribution/Underwriting sections. For other offering documents that are not subject to SEC Regulation S-K, prominent disclosure requires providing disclosure on the front page, a cross-reference to the discussion within the offering documents, and in the summary.

Under Rule 5121(a)(2), the participation of a qualified independent underwriter (QIU) may be required. FINRA Rule 5121(f)(12) defines the characteristics of a QIU. Generally, a QIU is an underwriter:

(A) that does not have a conflict of interest and is not an affiliate of any member that has a conflict of interest;

(B) that does not beneficially own as of the date of the member's participation in the public offering, more than 5% of the class of securities that would give rise to a conflict of interest, including any right to receive any such securities exercisable within sixty days;

(C) that has agreed in acting as a qualified independent underwriter to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act, specifically including those inherent in section 11 thereof; and

(D) that has served as underwriter in at least three public offerings of a similar size and type during the three-year period immediately preceding the filing of the registration statement or the date of first sale in an offering without a registration statement.

Generally, a QIU is required when there is a conflict of interest unless one of the following conditions is met:

- The book-running manager or dealer manager does not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest, and meets the disciplinary history requirements of Rule 5121;
- The securities offered have a "bona fide public market";[179] or
- The securities offered are fixed-income or preferred securities that have been rated investment grade[180] or are in the same series that have equal rights and obligations as investment grade securities.

[F][3] Filing Requirements Under Rule 5121

Generally, notwithstanding the availability of a filing exemption under Rule 5110, a transaction requiring a QIU must be filed with FINRA. An exception exists for a shelf-takedown where the base prospectus has previously been cleared with FINRA.

§ 49:7 Gifts and Entertainment

§ 49:7.1 Gifts Over $100 Are Not Permitted

FINRA Rule 3220 (Influencing or Rewarding Employees of Others) provides that: "No member or person associated with a member shall, directly or indirectly, give or permit to be given anything of value,

179. A bona fide public market is defined in Rule 5121(f)(3) as a market for a security of an issuer that has been reporting under the Exchange Act for at least ninety days and is current in its reporting requirements, and whose securities are traded on a national securities exchange with an Average Daily Trading Volume (as used in SEC Regulation M) of at least $1 million, provided that the issuer's common equity securities have a public float value of at least $150 million.

180. Investment grade securities are those securities rated by a nationally recognized statistical ratings organization in one of its four highest generic ratings categories. *See* Rule 5121(f)(8).

including gratuities, in excess of one hundred dollars per individual per year to any person, principal, proprietor, employee, agent or representative of another person where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity."

The prohibitions of this rule are intended to avoid improprieties, or the appearance thereof, that may arise in consequence of a broker-dealer or associated persons receiving substantial gifts from or making payments to certain other persons without those persons' employers' authorization and approval.[181]

The basic prohibition is meant to prevent behavior that may create a conflict of interest between the recipient of the gift and his or her employer.

[A] Scope and Exclusions of Rule 3220

The scope of the rule is limited by the connection of the gift to the business of the employer.

Presumptively, a gift the cost of which is borne by the employer, directly or indirectly, is a gift "in relation to the business of the employer."[182] However, gifts of *de minimis* value or promotional paraphernalia of nominal value are exempt from the rule. For this exemption to apply, the gift in question must be substantially below the $100 limit. Thus such items as pens, notebooks, or logo-bearing tote bags and umbrellas meet the criteria.

Also excluded from the prohibitions of Rule 3220 are decorative items commemorating a business transaction.[183] In such cases, gifts are permissible even when their cost is greater than $100. It is important, however, that the gift has no other use apart from decoration; otherwise the exemption does not apply.

Bereavement gifts, which are "customarily perishable and intended to comfort the recipient or the recipient's family during their time of mourning," are deemed not be "in relation to the business of the employer of the recipient," and are therefore not within the ambit of FINRA Rule 3220.[184] There is no fixed spending limit for bereavement gifts; however, such gifts must be reasonable and customary.

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181. FINRA Notice to Members 93-8 (Feb. 1993) (announcing SEC approval of an amendment to Article III, section 10(a) of the NASD Rules of Fair Practice, which section was designated as NASD Rule 3060 in 1996, which subsequently was superseded by FINRA Rule 3220 in the FINRA rulebook consolidation process).
182. FINRA Notice to Members 06-69, at 2 (Dec. 2006) (providing additional guidance on Rule 3220).
183. *Id*.
184. SIFMA, Letter on Reasonable and Customary Bereavement Gifts (Dec. 17, 2007).

[B] Supervision and Recordkeeping

Rule 3110 mandates that broker-dealers have in place a supervisory system designed to meet the requirements of Rule 3220. In pertinent part, Rule 3110 provides that "Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA Rules."[185] Accordingly, broker-dealers are required to ensure that gifts connected to the business of the firm are "(i) reported to the firm, (ii) reviewed for compliance with Rule 3220 and (iii) maintained in the firm's records."[186]

The prohibitions of Rule 3220 are against gifts of $100 or more per individual person per year. It is therefore necessary that firms aggregate all gifts given by them and their affiliates to individual persons in the course of a year. Where a gift is given to a group the value should still be accounted, on a pro rata basis, for each individual. The firm must then state, in accordance with FINRA guidance, whether the aggregated figure for each individual recipient is computed on a calendar year, fiscal year or on a rolling basis.[187] The value of gifts recorded by a broker-dealer should be accounted at the higher of cost or market value minus tax and delivery charges.[188] For tickets, the value to be used for accounting purposes is the higher of the cost or the face value.

§ 49:7.2 Entertainment Must Be Reasonable and Customary

[A] Generally

The NASD, in a 1999 interpretive letter, made a distinction between gifts and business entertainment. The letter established that firms are permitted to offer "ordinary and usual business entertainment" to persons covered under FINRA Rule 3220 (at the time, NASD Conduct Rule 3060) without consideration of the $100 limit, provided the entertainment is "neither so frequent nor so extensive as to raise any question of propriety."[189]

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185. FINRA Rule 3110(b).
186. FINRA Notice to Members 06-69, at 3 (Dec. 2006) (providing additional guidance on Rule 3220). This requirement is typically met through the maintenance of a gifts log. In many (but not all) cases, these are now automated.
187. *Id*. at 2.
188. *Id*.
189. Letter from FINRA, to T. Rowe Price Investment Services, Inc. (June 10, 1999).

In 2006, the NASD proposed interpretative material to Conduct Rule 3060 (IM-3060) so as to provide more guidance on the conduct of business entertainment. As with the guidance concerning gifts, the overarching principle of IM 3060 is to prevent conduct that is intended to cause, or may appear to have the effect of causing, the employee of a client to act contrary to the interests of his or her employer.

Business entertainment, under IM-3060, consists of any social, charitable, entertainment and such other event, and the associated transportation and accommodation, in which a firm or an associated person participates.[190] (Whatever item of value not considered "business entertainment" that is given to a person in connection with an employer's business constitutes a gift under Rule 3220.)

[B] Supervision and Recordkeeping

Compliance guidelines in relation to business entertainment:

- Firms must define the suitable forms of business entertainment with specificity, highlighting, for example, appropriate and inappropriate venues.
- Without necessarily prescribing a figure, IM-3060 requires firms to establish dollar limits or thresholds for entertainment expenditure and to approve such expenditure in advance.
- Firms must also maintain policies and procedures that are reasonably designed to achieve compliance with applicable gifts and entertainment regulations.
- Records should be maintained of business entertainment activities and expenses and such information made available upon request to employers, in relation to their employees, with whom the broker-dealer does business.
- Written procedures should also provide for the proper training of personnel concerning business entertainment and that persons designated to oversee this matter are qualified to do so.

§ 49:7.3 FINRA Has Proposed Revisions to Its Gifts Rule

In December 2014, FINRA published a report regarding its review of its gifts, gratuities, and non-cash compensation rules.[191] In the report, FINRA recommended exploring certain rule amendments to

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190. Notice to Members 06-06 (Jan. 2006) (addressing Gifts and Business Entertainment).
191. FINRA, Retrospective Rule Report: Gifts, Gratuities and Non-Cash Compensation (Dec. 2014).

better align investor protection benefits and the economic impacts. In August 2016, FINRA requested comment on certain proposed revisions to its current rule and guidance.[192] The comment period expired in September 2016, but since that time there have been no further official communications from FINRA regarding the proposed rule changes and FINRA has not submitted a rule change proposal to the SEC in this respect.

The proposed revisions on which FINRA requested comment would, among other changes:

- Increase the $100 limit on gifts (per recipient, per year) to $175, which would take into account the rate of inflation since the current limit was adopted in 1992.
- Incorporate into the rule certain interpretive guidance previously issued, including NASD Notice to Members 06-69 and the Bereavement Gift Guidance Letter, both discussed above.
- Establish a separate rule regarding business entertainment, to be numbered FINRA Rule 3222. This rule would consolidate existing interpretive guidance regarding business entertainment, and require each member to adopt written policies and procedures relating to business entertainment tailored to its business needs under a principles-based approach.

§ 49:8 Licensing, Registration, and Exemptions from Registration

§ 49:8.1 U.S. Licensing: Series 7, 24, and 79

[A] Generally

Broker-dealer personnel are subject to individual registration under FINRA rules. Individuals ("associated persons") of a broker-dealer may, depending on their function, be required to be registered. The broker-dealer with whom associated persons are registered bears the responsibility for monitoring the individual's business dealings. There are two categories of registration-representatives and principals.

Representatives are persons associated with a FINRA member "who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions."[193]

192. FINRA Regulatory Notice 16-29 (Aug. 2016).
193. NASD Membership and Registration Rule 1031(b).

The "principal" category encompasses persons "who are actively engaged in the management of the member's investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions."[194] Under FINRA rules, all members are required to have at least two registered principals.[195]

Both representatives and principals are required to take qualification examinations, often referenced by series numbers, the successful completion of which is a prerequisite for registration.

[B] Series 7

This examination is the General Securities Representative Qualification Examination. It is intended to "assess the competency of entry-level General Securities Representatives."[196] The purpose of the assessment is to protect the investing public by ensuring the competency of broker-dealers.

[C] Series 24

This examination is the General Securities Principal Qualification Examination. It is "designed to test a candidate's knowledge of the rules and statutory provisions applicable to the management of a general securities broker-dealer."[197] The purpose of the assessment is to ensure that principals are able to effectively supervise broker-dealer activity and observe compliance with pertinent rules and regulations.

[D] Series 79

This examination is the Investment Banking Representative Qualification Examination. It assesses the competency of entry-level investment bankers with the aim of protecting "the investing public by seeking to measure the degree to which each candidate possesses the knowledge, skills and abilities needed to perform the major functions of an entry-level investment banker."[198]

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194. NASD Membership and Registration Rule 1021(b).
195. NASD Membership and Registration Rule 1021(e)(1).
196. FINRA General Securities Representative Qualification Examination: Content Outline (2012).
197. FINRA General Securities Principal Qualification Examination: Study Outline (2012).
198. FINRA Investment Banking Representative Qualification Examination: Content Outline (2012). Under Rule 1032(i), an associated person engaged in advising or facilitating private or public offerings of securities, or advising or facilitating mergers, acquisitions, tender offers, financial restructuring, asset sales and divestitures, or corporate reorganization is required to pass the Series 79 examination. Note, however, that the sales function by itself does not require that license if conducted outside of structuring and/or organization.

§ 49:8.2 Activities of Non-U.S. Broker-Dealers

Broker-dealers located outside the United States that undertake securities transactions in the United States are required to register with the SEC. However, Rule 15a-6 allows foreign broker-dealers, who are not registered under the Exchange Act, to conduct certain limited activities in the United States and with U.S. persons without registering with the SEC. Under the rule, foreign broker-dealers may, subject to several conditions:

(i) effect "transactions in securities with or for persons that have not been solicited by the foreign broker or dealer,"[199]

(ii) furnish "research reports to major U.S. institutional investors, and effect transactions in the securities discussed in the research reports with or for those major U.S. institutional investors,"[200]

(iii) "induce the purchase or sale of any security by a U.S. institutional investor or a major U.S. institutional investor,"[201] and, among other things,

(iv) enter into securities transactions with SEC-registered broker-dealers, certain qualified U.S. banks, specific multilateral organizations, foreign persons temporarily in the United States, U.S. citizens resident abroad, and foreign branches and agencies of U.S. Persons.[202]

The Staff of the Division issued two important "no-action" letters, one in 2012 and the other in 2013, describing different means by which a non-U.S. broker-dealer may engage in certain M&A advisory activities without registration in accordance with Rule 15a-6.[203] The 2012 letter, to E&Y Canada, stated that a Canadian M&A advisor could advise in respect of U.S. M&A transactions, provided that the following criteria are met:

- the transaction is a "private placement of stock or other forms of equity securities in the context of mergers or acquisitions that would result in the transfer of control of an entire company or business unit,"[204]

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199. SEC Rule 15a-6.
200. *Id.*
201. *Id.*
202. *Id.*
203. SEC No-Action Letter (Re: Merger and Acquisition Activities of Foreign Firms in Reliance on Rule 15a-6) (July 12, 2012).
204. *Id.*

- the customer's total assets amount to $100 million, including assets that do not qualify as "financial" assets under the Nine Firms Letter (but excluding cash and cash equivalents),[205]
- the total assets are calculated without factoring in the potential transaction, as described in the Nine Firms Letter,[206]
- the customer's balance sheet, or comparable financial statement, is prepared in accordance with generally accepted accounting principles by a certified public accountant (or the non-U.S. equivalent, if appropriate), and
- if goodwill or intangibles are included in calculating the $100 million threshold, the customer's financial statements must be (a) audited and (b) prepared in accordance with, or reconciled to, U.S. Generally Accepted Accounting Principles (or International Financial Reporting Standards, if appropriate).

The 2013 letter, to Roland Berger Strategy Consultants, permits a non-U.S. advisor to act in the following ways in respect of M&A transactions:

- initiate contact directly with potential U.S. targets and engage in certain additional activities,
- interact with "a U.S. target that is using internal or group level personnel with relevant M&A experience to negotiate the transaction, if the internal or group level personnel described above are not associated with a U.S. registered broker-dealer, provided [the advisor's] personnel engaged in any contacts with U.S. Targets in the United States are limited to persons whom [the advisor] would have determined satisfy the requirements for 'foreign associated persons' in Rule 15(a)-6(a)(3)(B),"[207] or
- interact with "a U.S. Target that is using the services of an external advisor, such as a broker-dealer, attorney or other professional with relevant experience,"[208] provided that:

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205. *See* SEC No-Action Letter (Re: Securities Activities of U.S.-Affiliated Foreign Dealers) (Apr. 9, 1997) ("Nine Firms Letter"). "Financial" assets, under the Nine Firms Letter, are limited to "cash, money-market instruments, securities of unaffiliated issuers, futures and options on futures and other derivative instruments."
206. *Id*. "[T]otal assets," under the Nine Firms Letter, are "calculated on a gross basis, without deduction for liabilities of the company, based on the balance sheet or comparable financial statements of the company prepared in the ordinary course of business."
207. Roland Berger Strategy Consultants, SEC No-Action Letter (May 28, 2013).
208. *Id*.

- the M&A advisor "will not represent any U.S. Target and will not receive, acquire or hold funds or securities."[209]

§ 49:8.3 January 2014 FINRA Letter Regarding M&A Brokers

On January 31, 2014, the Staff of the Division issued a "no-action" letter permitting persons who qualify as "M&A Brokers" to facilitate the sale of private companies without registering with the SEC as broker-dealers,[210] provided that the following criteria are met:

- the M&A Broker must not have the ability to bind either party to the M&A transaction;
- the M&A Broker must not provide financing for the transaction, and if the M&A Broker assists in finding financing, it must disclose any compensation in connection with that role in writing to the client;
- the M&A Broker must not control securities or funds related to the transaction;
- the transaction cannot involve a public offering;
- if the M&A Broker represents both parties, written disclosure and consent must be obtained;
- the M&A Broker can only facilitate a transaction with multiple buyers if the group was formed without assistance of the M&A Broker;
- the buyer must control and actively operate the company when the transaction is complete;
- the transaction cannot transfer an interest to a passive buyer;
- any securities the M&A Broker or the buyer receive must be restricted securities;
- the M&A Broker cannot have been suspended or barred from association with a broker-dealer by the SEC, FINRA, or any state regulator; and
- the M&A Broker cannot engage in certain activities traditionally associated with a broker-dealer, such as participation in private placements (other than M&A transactions, as described), intermediation of secondary market transactions (including private

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209. *Id.*
210. M&A Brokers, SEC No-Action Letter (Jan. 31, 2014).

sales of "less than" control stakes), market making, other secondary market trading; securities lending and finance (including advisory), underwriting or other capital leasing, public M&A (M&A transactions involving a public offering); and receipt of other than restricted securities by the M&A Broker.

§ 49:9 Anti-Money Laundering (AML)

§ 49:9.1 AML Program

The PATRIOT Act[211] requires financial institutions to establish AML programs. The minimum AML standards are provided under section 352 of the PATRIOT Act. Broker-dealers are deemed to be compliant if they observe the AML programs required by their federal regulators or designated SRO.[212]

Financial institutions are further required to comply with the economic and trade sanctions programs administered by the Office of Foreign Assets Control (OFAC). Prior to the opening of a new account or commencement of a transaction, broker-dealers must ensure that potential clients are not listed on the OFAC's Specifically Designated Nationals and Blocked Persons List ("SDN List") or are "Prohibited Persons" under OFAC's sanctions program, and that prohibited financial instruments are not folded into the transaction.[213]

§ 49:9.2 OFAC Compliance

A broker-dealer's OFAC obligations continue after the establishment of a customer account.

The SDN List is periodically updated. As a result, firms need to periodically screen their databases of existing accounts and securities in custody against the updated lists.

In the event that a firm discovers any prohibited securities or accounts held by, or on behalf of, a Prohibited Person, it should take appropriate action depending on the applicable sanctions regime.

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211. 115 Stat. 272 (2001).
212. SIFMA's Anti-Money Laundering and Financial Crimes Committee, 2008: Guidance for Deterring Money Laundering and Terrorist Financial Activity, at 4 (Feb. 2008). One recent issue U.S. financial institutions have had to consider is the AML treatment of customers that are involved in marijuana-related business that are legal on the state level. In 2014, the Financial Crimes Enforcement Network (FinCEN) issued Guidance FIN-2014-G001 clarifying Bank Secrecy Act expectations for financial institutions seeking to provide services to marijuana-related businesses.
213. *See generally* U.S. DEPT. OF THE TREASURY, FOREIGN ASSETS CONTROL REGULATIONS FOR THE SECURITIES INDUSTRY, at 2–3 (Apr. 29, 2004).

The firm may be "obligated either to (a) reject the transaction, or (b) freeze the funds or securities and establish a blocked account to hold the frozen assets."[214]

Following the rejection of a transaction or the freezing of an account, the broker-dealer is required to notify OFAC by the submission of the applicable reporting form within ten days. An annual report on blocked property must also be filed with OFAC by September 30 of each year.[215]

Broker-dealers, though not required by law to implement this, are advised to create internal OFAC compliance programs appropriate for their individual risk profiles. A firm's risk profile may be determined by a combined analysis of its products, services, client base, and geographic location. The Federal Financial Institutions Examination Council has on its website a manual to assist in this connection.[216]

As a general matter, a broker-dealer's OFAC compliance program should have an appointed person with an oversight function and be subject to independent verification of its effectiveness. In addition, appropriate personnel must receive proper training in OFAC compliance.

§ 49:9.3 *KYC Compliance*

A firm's Know Your Customer (KYC) policy is a cornerstone of an AML compliance program. On October 1, 2003, the U.S. Department of the Treasury and the SEC jointly issued the customer identification program rule (the "CIP Rule") for broker-dealers.

The CIP Rule requires broker-dealers to implement, document, and maintain a written CIP that is integrated within the firm's general AML program. Pursuant to NYSE Rule 445 and NASD Rule 3011, a broker-dealer's CIP must be approved by its senior management. Overall, a firm's CIP must provide it with grounds for a reasonable belief that it knows the persons with whom it transacts.

Key aspects of the CIP Rule include collecting sufficient identification information from customers upon the opening of new accounts and subsequently verifying that information within a reasonable time by, among other things, checking for customer identities on known and suspected terrorist lists.

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214. SIFMA, ANTI-MONEY LAUNDERING AND FINANCIAL CRIMES COMMITTEE, 2008: GUIDANCE FOR DETERRING MONEY LAUNDERING AND TERRORIST FINANCIAL ACTIVITY, at 4 (Feb. 2008).

215. See OFAC forms for filing reports on blocked and rejected transactions and annual reports, http://www.treasury.gov/offices/enforcement/ofac/forms/index.shtml.

216. *See* FFIEC BSA/AML EXAMINATION MANUAL, http://www.ffiec.gov/bsa_aml_infobase/documents/bsa_aml_man_2010.pdf.

Under the CIP Rule, a customer is a person who opens a new account with a broker-dealer or a person who opens a new account on behalf of another person or of an entity.[217] There are exclusions from the definition of customer, which cover, *inter alia*, entities that have existing accounts with a broker-dealer, entities that present little danger of money laundering such as government entities, and entities regulated by the federal government in other ways. In 2016, FinCEN adopted new anti-money laundering regulations that impose additional customer due diligence requirements on covered financial institutions, including broker-dealers, referred to as the "CDD Rule." Specifically, the CDD Rule requires broker-dealers "to establish and maintain written procedures that are reasonably designed to identify and verify beneficial owners of legal entity customers" that open new accounts "and to include such procedures in their anti-money laundering compliance program."[218] While in the past broker-dealers were only required to establish customer information in connection with account holders, the new CDD Rule now required broker-dealers to "look through" in order to identify and verify the identity of the beneficial owners of each legal entity customer.[219]

The definition of the term "account" under the CIP Rule is very broad, and encompasses not only traditional transactions such as the purchase and sale of securities but also such dealings as securities lending and borrowing and the holding of securities or other assets for safekeeping or as collateral.[220] However, accounts acquired by broker-dealers through acquisition, merger, purchase of assets, or assumption of liabilities, or accounts opened for the purpose of participating in an ERISA employee benefit plan are not considered "accounts" under the CIP Rule.[221]

There are three items that broker-dealers must undertake to comply with the CIP Rule: (1) broker-dealers must obtain certain specified information regarding each customer before opening an

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217. *See* CIP Rule, sec. (a)(4).
218. *See* CDD Rule, 31 C.F.R. § 1010.230(a).
219. A "legal entity customer" is defined as any corporation, limited liability company, or other entity that is created by the filing of a public document with a secretary of state or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction, that opens an account. Note that public companies and certain entities that are subject to a pre-existing regulatory regime, such as generally registered investment companies, investment advisers, and broker-dealers are excluded from the definition of "legal entity customer." *See* CDD Rule, 31 C.F.R. § 1010.230(e)(1) and 31 C.F.R. § 1010.230(e)(2).
220. *See* CIP Rule, 31 U.S.C. § 103.122, sec. (a)(1)(i).
221. *See* 68 Fed. Reg. 25 at 113 (May 9, 2003).

account; (2) they must verify such information within a reasonable time before or after the opening of the account; and (3) they must specify in their CIP procedures when they will rely on identification procedures that are documentary (for example, photographic ID) or non-documentary (for example, checking the customer's references with other financial institutions). In addition, the CIP Rule requires broker-dealers to maintain records of the preceding measures and the descriptions of the manner in which discrepancies discovered in the client identification process are resolved.

A broker-dealer may rely on the performance of CIP procedures by another financial institution with which it has an account relationship. Such reliance is subject to the following provisions: (1) that it be reasonable under the circumstances, (2) that the other financial institution be regulated by a federal functional regulator and required to implement an AML compliance program, and (3) that the broker-dealer has annually certified to the relying financial institution requiring the latter to attest that it has an AML program meeting the applicable requirements and will undertake the performance of specified CIP obligations.[222]

§ 49:10 IPO Allocation and Client Sophistication

§ 49:10.1 IPO Allocation

[A] Overview

FINRA Rules 5130 and 5131 restrict FINRA members with respect to the purchase, sale, and allocation of new issues. Rules 5130 and 5131 serve an overarching purpose: to prevent broker-dealers from allocating securities to individuals in a position to direct brokerage or investment banking business back to the broker-dealer. FINRA Rule 5130 specifically aims to prevent the allocation of securities to other broker-dealers and other restricted persons (as defined below) to prevent quid-pro-quo arrangements with individuals in a position to direct brokerage business back to the allocating broker-dealer. Correspondingly, Rule 5131 aims to prevent the allocation of IPO securities to persons that are in a position to direct investment banking business back to the allocating broker. As a practical matter, investment funds face certification requirements under Rules 5130 and 5131 by making annual representations about their eligibility to acquire new issues.

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222. 31 C.F.R. § 103.122(b)(6). Note also that in accordance with specified SEC guidance, reliance on the CIP of a U.S. registered investment adviser is permitted, notwithstanding that investment advisers are not formally required to maintain AML programs.

[B] FINRA Rule 5130—the "New Issue" Rule

Rule 5130 prohibits the purchase and sale of new issue securities to accounts in which a "restricted person" has a beneficial interest.[223]

In addition to exempting certain types of accounts,[224] the Rule creates a *de minimis* holdings exception. Rule 5130(c)(4) exempts

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223. "Restricted persons" include FINRA members and other broker-dealers, broker-dealer personnel, finders and fiduciaries, portfolio managers, owners of broker-dealers, and certain immediate family members of these persons. Principals and employees of fund managers are generally restricted persons. For a complete list, see FINRA Rule 5130(i)(10)(A)–(E).

224. Both Rule 5130 and 5131 except from their prohibitions certain types of accounts. These accounts include:

   (1) An investment company registered under the Investment Company Act;

   (2) A common trust fund or similar fund as described in Section 3(a)(12)(A)(iii) of the Exchange Act, provided that:

      (A) the fund has investments from 1,000 or more accounts; and
      (B) the fund does not limit beneficial interests in the fund principally to trust accounts of restricted persons;

   (3) An insurance company general, separate or investment account, provided that:

      (A) the account is funded by premiums from 1,000 or more policyholders, or, if a general account, the insurance company has 1,000 or more policyholders; and
      (B) the insurance company does not limit the policyholders whose premiums are used to fund the account principally to restricted persons, or, if a general account, the insurance company does not limit its policyholders principally to restricted persons;

   (4) An account if the beneficial interests of restricted persons do not exceed in the aggregate 10% of such account;

   (5) A publicly traded entity (other than a broker-dealer or an affiliate of a broker-dealer where such broker-dealer is authorized to engage in the public offering of new issues either as a selling group member or underwriter) that:

      (A) is listed on a national securities exchange; or
      (B) is a foreign issuer whose securities meet the quantitative designation criteria for listing on a national securities exchange;

   (6) An investment company organized under the laws of a foreign jurisdiction, provided that:

      (A) the investment company is listed on a foreign exchange for sale to the public or authorized for sale to the public by a foreign regulatory authority; and
      (B) no person owning more than 5% of the shares of the investment company is a restricted person;

accounts from IPO allocation restrictions where holdings of restricted persons, in the aggregate, comprise no more than 10% of the beneficial ownership[225] of the collective investment account. The investment vehicle may comply with the 10% "de minimis" exemption by limiting the profit and loss from new issue securities allocated to restricted persons to no more than 10% through a "carve-down" or similar procedure. This "carve-down" procedure is one of the principal ways in which investment funds comply with the Rule.

[C] Practical Compliance Steps

In order to comply with the requirements of Rule 5130, broker-dealers must ask private investment funds, including hedge funds, to make a representation regarding their eligibility to acquire IPO securities.

In order to make that representation, collective investment vehicles such as funds will need to confirm that the aggregate beneficial ownership of restricted persons among their investors has not changed since the certifications made in the subscription documents and that this aggregate does not exceed the 10% threshold.

Third-party vendors collect databases of eligible purchasers and make those databases available to broker-dealers.

[D] Frequency of Representation

FINRA members must ensure that these representations are given annually, while the initial representation by a fund manager to a FINRA member must be an affirmative representation, it thereafter may be updated annually using negative consent letters.

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(7) An Employee Retirement Income Security Act benefits plan that is qualified under Section 401(a) of the Internal Revenue Code, provided that such plan is not sponsored solely by a broker-dealer;

(8) A state or municipal government benefits plan that is subject to state and/or municipal regulation;

(9) A tax-exempt charitable organization under section 501(c)(3) of the Internal Revenue Code; or

(10) A church plan under section 414(e) of the Internal Revenue Code.

See FINRA Rule 5130(c)(1)–(10) and FINRA Rule 5131(b)(2) adopting the exceptions laid out in FINRA Rule 5130(c).

225. "Beneficial interest" or "beneficial ownership" is defined in Rule 5130(i)(1) to mean any economic interest, such as the right to share in gains or losses. The receipt of a management or performance based fee for operating a collective investment account, or other fees for acting in a fiduciary capacity, is not considered to be a beneficial interest in the account.

[E] FINRA Rule 5131(b): The Prohibition on Spinning

[E][1] Generally

Rule 5131(b) prohibits the allocation by a FINRA member of new issue securities to any account (including, as in Rule 5130, any investment fund or other collective investment vehicle) in which an executive officer or director of a "public company"[226] or "covered non-public company"[227] has a beneficial economic interest,[228] (including the right to share in gains or losses), if:

(1) the company is currently an investment banking client of the member;

(2) in the twelve-month period prior to the allocation, the member received compensation from the company for investment banking services;

(3) the FINRA member expects to provide or be retained for investment banking services in the three-month period following the allocation; or

(4) such allocation is made on the condition that such executive officer or director, on behalf of the company, retain the member for performance of future investment banking services.

[E][2] 25% De Minimis *Test for Collective Investment Accounts*

Rule 5131 permits allocations of new issues to an account, including a collective investment vehicle such as a fund, in which the collective beneficial interests of executive officers and directors of a particular company and persons materially supported by such executive officers and directors in the aggregate are less than 25% of such account. By contrast, the analogous exemption in Rule 5130 described

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226. A "public company" is any company that is registered under section 12 of the Exchange Act or files periodic reports pursuant to section 15(d) thereof. FINRA Rule 5131(e)(1).

227. "Covered non-public company" means any non-public company satisfying the following criteria: (i) income of at least $1 million in the last fiscal year or in two of the last three fiscal years and shareholders' equity of at least $15 million; (ii) shareholders' equity of at least $30 million and a two-year operating history; or (iii) total assets and total revenue of at least $75 million in the latest fiscal year or in two of the last three fiscal years. FINRA Rule 5131(e)(3).

228. *See* FINRA Rule 5131(e)(2) adopting the definition of "beneficial interest" as set out in FINRA Rule 5130(i)(1).

above applies to accounts in which restricted persons have an aggregate beneficial interest of no greater than 10%.[229]

[F] 2013 Amendment to Rule 5131

In 2013, the SEC approved an amendment to Rule 5131 that allowed a fund-of-funds to rely on a written representation obtained within the prior twelve months from an unaffiliated private fund that does not look through to its beneficial owners, provided that the unaffiliated private fund meets certain other indicia of independence. Specifically, the unaffiliated private fund must: (a) be managed by an investment adviser; (b) have assets greater than $50 million; (c) own less than 25% of the account and not be a fund in which a single investor has a beneficial interest of 25% or more; and (d) not have been formed for the specific purpose of investing in the account.[230]

The amendment's relief does not extend to beneficial owners that are control persons of the investment adviser to the applicable unaffiliated private fund. The account (for example, fund-of-funds) does, therefore, need to look through to its beneficial owners to the extent that such beneficial owners are control persons of the applicable unaffiliated private fund.

[F][1] Other IPO Allocation Regulations Set Forth in Rule 5131

[F][1][a] Quid Pro Quo Allocations

Rule 5131(a) prohibits the offer of new issue securities or the threat to withhold new issue securities as consideration or inducement for the receipt of compensation that is "excessive" in relation to the services provided to the customer by the FINRA member.[231]

[F][1][b] Policies Concerning Flipping

Rule 5131(c) prohibits FINRA members from penalizing registered representatives of a FINRA member whose customers have "flipped" a

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229. Additionally, Rule 5131, like Rule 5130, is both a threshold exemption and an allocation device, permitting a fund to limit the profit and loss from new issue securities to no more than twenty-five percent.

230. For more information on the amendment to Rule 5131, see SHEARMAN & STERLING, SEC APPROVES AMENDMENT TO FINRA IPO ALLOCATION RULE 5131, EASING COMPLIANCE FOR FUND INVESTORS (Dec. 6, 2013) (client publication). FINRA has in its interpretive guidance clarified that, for purposes of this provision, a family office qualifies as an "investment adviser."

231. *See* FINRA Rule 5131(a). Whether or not compensation is "excessive" is based upon all of the relevant facts and circumstances, including, where applicable, the level of risk and effort involved in the transaction and the rates generally charged for such services. Regulatory Notice 10-60 adopting the rule [hereinafter SEC Adopting Notice].

new issue, unless a penalty bid has been imposed on the member by the managing underwriter.

FINRA members must promptly record and maintain information regarding any penalties or disincentives assessed on their associated persons in connection with a penalty bid.

[F][1][c] New Issue Pricing and Trading Practices

[F][1][c][i] Reports of Indications of Interest and Final Allocations

Under FINRA Rule 5131(d)(1), the book-running lead manager must provide to the issuer a report of indications of interest, including the names of interested institutional investors and the number of shares indicated by each, and a report of aggregate demand from retail investors, and after the IPO settlement date, a report of the final allocation of shares.[232]

[F][1][c][ii] Restriction on Transfer of the Issuer's Shares by Officers and Directors of the Issuer

Under Rule 5131(d)(2), any lock-up agreement or other restriction on the transfer of the issuer's shares by officers and directors and directors of the issuer entered into in connection with a new issue must provide that such restrictions will also apply to any issuer-directed shares received by such officers or directors.

The agreement must also require that at least two business days prior to the release of any lock-up, the lead manager will notify the issuer and make an announcement through a major news services. In essence, underwriters are not permitted to waive lock-ups without providing prior notice to market participants.[233]

[F][1][c][iii] Agreement Among Underwriters

Under Rule 5131(d)(3), the agreement among syndicate members must provide that, to the extent not inconsistent with Regulation M, shares trading at a premium to the IPO price returned by a purchaser to a syndicate member after trading commences will be allotted to the syndicate short position.[234]

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232. *See* FINRA Rule 5131(d)(1).

233. FINRA confirms that these provisions apply only to lock-up agreements entered into in connection with a new issue. *See* Rule 5131(d)(2) and the SEC Adopting Notice, *supra* note 231, at 18. *See* FINRA Rule 5131(d)(2).

234. If no short position exists, the member must offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology or sell returned shares on the secondary market

[F][1][c][iv] Market Orders

Under Rule 5131(d)(4), no FINRA member may accept a market order for the purchase of shares of a new issue in the secondary market prior to the commencement of trading of such shares in the secondary market.

§ 49:10.2 QIB Certification

[A] Introduction

Rule 144A is a safe harbor exemption from the registration requirements of section 5 of the Securities Act for certain offers and sales of qualifying securities by certain persons other than the issuer of the securities. The exemption applies so long as the seller has a "reasonable belief" that the buyers of the securities are qualified institutional buyers, commonly referred to as "QIBs."

[B] Qualification As a QIB

In general, a QIB is any entity included within one of the categories of "accredited investor" defined in Rule 501 of Regulation D, acting for its own account or the accounts of other QIBs, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers not affiliated with the entity. While a QIB may be formed merely for the purpose of investing in a Rule 144A transaction, the amount of securities to be purchased in the Rule 144A offering cannot be included in calculating the amount of securities owned or invested by a QIB.[235]

[C] How a Broker-Dealer Qualifies As a QIB

In general, a broker-dealer qualifies as a QIB if it owns or invests on a discretionary basis at least $10 million in securities of issuers not affiliated with the entity. A broker-dealer acting as a riskless principal for an identified QIB would itself be deemed a QIB. To qualify as a riskless principal, the broker-dealer must have a commitment from the QIB that it will simultaneously purchase the securities from the broker-dealer. The QIB status must be effective at the time of purchase in the Rule 144A transaction.

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and donate profits from the sale to an unaffiliated charitable organization with the condition that the donation be treated as an anonymous donation to avoid any reputational benefit to the member. *See* FINRA Rule 5131(d)(3).

235. SEC Release No. 33-6862 (Apr. 23, 1990).

[D] Reasonable Belief

To satisfy the "Reasonable Belief" requirement, the reseller (and any person acting on any of the reseller's behalf) may rely on the following, provided the information is of a date not more than sixteen months (or eighteen months for a foreign purchaser) preceding the sale:

- The purchaser's most recent publicly available annual financial statements;
- Information filed with (a) the SEC, another U.S. federal, state or local governmental agency, or a self-regulatory organization, or (b) a foreign governmental agency or foreign self-regulatory organization;
- Information in a recognized securities manual; or
- A certification by the purchaser's chief financial or other executive officer specifying the amount of securities owned and invested as of a date on, or since, the end of the buyer's most recent fiscal year.

§ 49:10.3 FINRA Regulation of Suitability

[A] Introduction

FINRA Rule 2111 requires that a broker-dealer, prior to the recommendation of a transaction or investment strategy involving a security or securities, must have a reasonable basis to believe that the recommendation is suitable for the customer. The test for suitability is based on information obtained through the reasonable diligence of the member or associated person in ascertaining the customer's investor profile. There is no automatic or self-executing exception or exclusion from the suitability requirement for institutional or investment banking activities.

[B] Components of Suitability Obligations

Rule 2111 is composed of three main obligations: (1) reasonable-basis suitability, (2) customer-specific suitability, and (3) quantitative suitability.

[B][1] The Reasonable Basis Obligation

This obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least *some* investors. What constitutes reasonable diligence will vary depending on the facts of the situation.[236]

[B][2] The Customer-Specific Obligation

This obligation requires that a broker-dealer have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile, as delineated in Rule 2111(a).

[B][3] Quantitative Suitability

This requires a member or associated person who has actual or *de facto* control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a).

[C] Customers and Potential Investors

The suitability obligations attach when the transaction occurs but the suitability of the recommendation is evaluated based on the circumstances that existed at the time the recommendation to the customer was made.

[D] Institutional Suitability

FINRA Rule 2111(b) provides an exemption to customer-specific suitability for recommendations to institutional customers under certain circumstances. FINRA Rule 2111(b) defines an "institutional account" by reference to FINRA's "books and records" rule, Rule 4512(c). "Institutional account" means the account of a bank, savings and loan association, insurance company, registered investment company, registered investment adviser, or any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.[237]

A firm that receives an affirmative attestation of independent investment analysis and decision-making from an institutional customer fulfills its customer-specific obligation, but not its reasonable

236. Facts to be considered are the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. *See* Supplementary Materials to Rule 2111.

237. *See* FINRA Rule 4512(c).

basis and quantitative obligations under the suitability rule. FINRA has emphasized that, even when institutional customers are involved, it is crucial that brokers understand the securities they recommend and that those securities are appropriate for at least some investors. FINRA also believes that it is important that a firm not recommend an unsuitable number of transactions in those circumstances where it has control over the account. FINRA emphasizes, however, that quantitative suitability generally would apply only with regard to that portion of an institutional customer's portfolio that the firm controls and only with regard to the firm's recommended transactions.

[E] Suitability Requirements for Institutional Accounts

A broker-dealer fulfills the customer-specific obligation for an institutional account if:

(1) the member or associated person **has a reasonable basis to** believe that the institutional customer is capable of evaluating investment risks independently; and

(2) the institutional customer **affirmatively indicates** that it is exercising independent judgment in evaluating the broker dealer's recommendations. With respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account.

[F] Compliance with the Exception

In general, FINRA has stated that Rule 2111 generally does not impose explicit documentation requirements. Firms may take a risk-based approach to document compliance with the suitability rule.[238] The level of documented analysis will vary based on the complexity and risks associated with a particular security or investment strategy.[239] Although third-party vendors have created "Institutional Suitability Certificates" to facilitate compliance with the institutional customer exemption by obtaining suitability waivers from various institutional clients, FINRA has not approved or endorsed any specific certificate created by a third-party vendor. Furthermore, as FINRA Regulatory Notice 12-25 emphasizes, FINRA does not require

238. As stated in Regulatory Notices 11-25, 12-25, 12-55.
239. Regulatory Notice 12-55.

broker-dealers to use such certificates to comply with the exemption in Rule 2111(b). There are a number of ways to comply with the Institutional Customer Exemption. Some suggestions are enumerated below.

Firms may:

- Tailor account opening documents or separate forms or certificates through which the institutional customer acknowledges in writing that it will exercise independent judgment in evaluating recommendations.
- Contact institutional customers to discuss affirmative indications and documentation of the conversation.
- Use third-party vendors to verify the institutional status and sophistication of customers.

§ 49:11 Books and Records

§ 49:11.1 SEC Recordkeeping Requirements

[A] Introduction

SEC Rules 17a-3 and 17a-4 under the Exchange Act prescribe minimum standards for the creation, retention and preservation of records that apply to broker-dealers. The general principle behind the regulatory framework governing recordkeeping is that a FINRA broker-dealer must maintain records if it "intends to communicate, or permits its associated persons to communicate, through social media sites" and those electronic communications "relate to the firm's business as such."[240] In that respect, two core aspects of any record-retention program relating to an investment banking business are (1) email retention and (2) retention of the "deal file."

[B] Retention of E-mail and Text Messages

In the Electronic Records Release, issued in 1997, the SEC described the application of recordkeeping requirements to electronic communications.[241] Although electronic communications technology has evolved, the Electronic Records Release still establishes the basic principle underlying record-keeping requirements applicable to e-mail and text messages. The SEC in the Electronic Records Release stated that for record-retention purposes under Rule 17a-4, the content of the electronic communication is determinative. Therefore, broker-dealers

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240. SEC Electronic Delivery Release, *infra* note 246; SEC Electronic Records Release, *infra* note 246.
241. SEC Release No. 34-38245 (Jan. 1997).

must retain those e-mail and Internet communications which relate to the broker-dealer's "business as such."[242] Broker-dealers are required to preserve for a period of not less than three years, the first two years in an easily accessible place, originals of all communications received and copies of all communications sent by the firm or its employees relating to its business. These rules apply to electronic communications and text messaging as well.[243] Therefore, firms must ensure that their use of e-mails and text messages is consistent with these supervisory and retention obligations.

[C] Rule 17*a*-3 Recordkeeping Requirements

The required retention periods for various types of documents relating to a broker-dealer's business are set forth in Rule 17a-3. Most documents must be retained for periods of either three or six years, in either case for the first two years in an easily accessible place. However, certain kinds of documents must be retained for the life of the enterprise.

Some examples of applicable retention periods are as follows:

- Trade blotters, ledgers: Not less than six (6) years; two (2) years easily accessible.
- Order tickets: Not less than three (3) years; two (2) years easily accessible.
- Net capital records: Not less than three (3) years, two (2) years easily accessible.
- Business communications: Not less than three (3) years; two (2) years easily accessible.
- Employment records: At least three (3) years after the "associated person" has terminated employment.
- Fingerprint records: Life of enterprise, at least two (2) years easily accessible.
- Regulatory inquiries: Until three (3) years after date of the report, easily accessible.
- Exception reports: Until eighteen (18) months after the report was generated easily accessible and until three (3) years after termination of use.

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242. Electronic Records Release, *infra* note 246, at 16.

243. See, for example, the July 2016 FINRA enforcement action against Motilal Oswal Securities, in which FINRA imposed a fine for failure to retain WhatsApp and Bloomberg messages related to its business as such. *See* Motilal Oswal Sec. Int'l Priv. Ltd., Letter of Acceptance, Waiver and Consent (July 6, 2016).

[D] Communications with the Public

Rule 17a-3(a)(20) requires broker-dealers to document that they have complied with, or adopted policies and procedures reasonably designed to comply with, federal and SRO rules requiring that advertisements, sales literature, and other communications with the public be approved by a supervisory principal.

FINRA Rule 2210(b)(4)(A) sets forth the recordkeeping requirements for retail and institutional communications; generally, these requirements mirror current recordkeeping requirements. This provision incorporates by reference the recordkeeping format, medium and retention period requirements of SEC Rule 17a-4.[244] Specifically, Rule 2210(b)(4)(A) mandates that records must include:

(i) a copy of the communication and the dates of first and last use;

(ii) the name of the registered principal who approved the communication and the date approval was given;

(iii) in the case of a communication for which principal pre-use approval was not required, the name of the person who prepared or distributed the communication;

(iv) information concerning the source of any statistical table, chart, graph, or other illustration used in the communication; and

(v) for retail communications that rely on the exception under 2210(b)(1)(C), the name of the firm that filed the retail communication with FINRA and a copy of the Advertising Regulation Department's review letter.

FINRA Rule 2211(b)(2) requires firms to maintain records of institutional sales material for a period of three years.

Rule 17a-3(a)(22) requires broker-dealers to prepare a list of each principal of the firm responsible for establishing policies and procedures reasonably designed to ensure compliance with any applicable federal or SRO rule requiring the approval of a record by a principal.[245]

The SEC defers to SRO rules, including FINRA Rule 2210 (Communications with the Public) and Rule 2220 (Options Communications), for specific requirements regarding the content of advertisements, sales literature, and general correspondence.

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244. See the discussion of the record-retention requirements set forth in Rule 17a-4(b)(4) at *infra* section 49:11.2[A].

245. SEC Rule 17a-3(h)(2) defines a "principal" as any individual registered as a principal or branch manager of the firm, or any other person who has been delegated supervisory responsibility over associated persons by the firm.

§ 49:11.2 *Electronic Communications*

[A] Introduction

Two key releases by the SEC in 1996 and 1997 still serve to establish the basic principles that underlie current regulatory policy on electronic communication. The first release discussed the use of electronic media to deliver information to customers ("Electronic Delivery Release"); the second described the application of record-keeping requirements to electronic communications ("Electronic Records Release").[246]

The Electronic Records Release states:

> For record retention purposes under Rule 17a-4, the content of the electronic communication is determinative, and therefore broker-dealers must retain only those e-mail and Internet communications (including inter-office communications) which relate to the broker-dealer's "business as such."[247]

Rule 17a-4(b)(4) requires the preservation of almost every electronic document, including e-mail, letter, memoranda, and potentially instant messaging as well.[248] Under the Rule, all external and internal communications of the broker-dealer relating to its business must be retained.

[B] Key Elements of an Electronic Mail Compliance System

FINRA Rules do not specifically require member firms to review or approve internal communications. However, members must be certain that they have established a system that adequately supervises the activities of each registered representative and associated person, including their use of electronic communications technology.

Rule 17a-4(b)(3) and FINRA Rule 3110 require firms to preserve for a period of not less than three years, the first two in an easily accessible place, originals of all communications received and copies of all communications sent by the firm or its employees relating to its business. This includes electronic communications.

Records must be preserved "exclusively in a non-rewriteable, non-erasable format."[249] The archival system must have the ability to download indexes and records to practically any electronic medium

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246. SEC Release No. 34-37182 (May 1996) [hereinafter Electronic Delivery Release]; SEC Release No. 34-38245 (Jan. 1997) [hereinafter Electronic Records Release].
247. Electronic Records Release, at 16.
248. SEC Rule 17a-4(b)(4).
249. SEC Rule 17a-4(f)(2)(ii)(A).

required by the Commission or FINRA. A backup archive must be maintained in a separate location. Prior to implementing the electronic storage media system, the member, broker, or dealer is required to provide written notice to its examining authority. In many cases, this notice is required ninety days prior to implementation. The notice must confirm that the electronic storage media system the broker-dealer has employed meets the requirements of Rule 17a-4(f)(2)(ii)(A)–(D).

[C] Role of Third-Party Vendors

Under Rule 17a-4(f)(3)(vii), broker-dealers must have at least one independent third party with access to and the ability to download all exclusively electronically stored information. The third-party vendor must file a written undertaking with the designated examining authority agreeing to comply with Rule 17a-4 and provide the records upon reasonable request. The vendor must preserve those records in its custody and make them available upon request of the broker-dealer, to the SEC or FINRA.

§ 49:11.3 Social Networking and Social Media

[A] Static Content Regulation

FINRA considers static postings that are accessible to the public to constitute "retail communications" under Rule 2110, and as such requires an appropriately qualified registered principal of the firm to approve each retail communication before the earlier of its use or filing with FINRA. It is also necessary to keep records of all content and changes made. Examples of static content are static postings on blogs, social network profiles (such as LinkedIn profiles), and social network background images.

[B] Interactive Content Regulation

Prior principal approval is not required under Rule 2210 for interactive electronic forums. However, firms must supervise these interactive electronic communications under FINRA Rule 3110 in a manner reasonably designed to ensure that they do not violate the content requirements of FINRA's communications rules.

[C] Personal Devices in Business Communications

Due to the development of new technologies and their ability to aid persons of the firm to perform their duties as well as serve their clients, FINRA permits the use of any personal communication device, but requires that business communications of FINRA members be retained, regardless of the storage format.

[C][1] Compliance on a Personal Device

The firm representative must have the ability to retain, retrieve, and supervise the communication, which must be of a business matter. Practically speaking, this means that whether a person is communicating on social networks via a smartphone, iPad, or computer, they must retain their business communications for record-keeping purposes.

[D] Third-Party Posts

[D][1] Overview

Generally, customer and other third-party posts on a social media website are not considered firm communications and do not trigger Rule 2210 requirements.

[D][2] Exceptions

Exceptions to the general rule that may result in attribution of third-party posts to the firm include "entanglement," where the firm was involved in the preparation of the content, and "adoption," where the firm has given its explicit or implicit endorsement or approval of the content.

[D][3] Compliance Strategies

To avoid a finding of entanglement or adoption, FINRA has provided the following guidance as suggested best practices when dealing with third-party posts:

- Monitor third-party posts;
- Include a disclaimer on firm sites;
- Establish user guidelines for third parties that post on firm sites;
- Establish screening procedures for third-party content; and
- Disclose policies with respect to firm responsibility for third-party posts.

[E] Third-Party Links

Firms may not establish a link to any third-party site that it knows or has reason to know contains false or misleading content. A firm that co-brands any party of a third-party site, such as by placing the firm's logo prominently on the site, is responsible for the content of the entire site.

[F] Data Feeds

Firms must adopt procedures to manage data feeds into their own websites. Firms must be familiar with the proficiency of the vendor of the data and its ability to provide data that is accurate as of the time it is presented on the firm's website.

Firms should regularly review aspects of these data feeds for any red flags that indicate the data might not be accurate, and should promptly take necessary measures to correct any inaccurate data.

[G] Recordkeeping

The key principle in keeping records of communication via social networks remains the same across all communication media: broker-dealers must retain electronic social media in a manner that can be reproduced as of any prior time.

Specifically, Regulatory Notice 11-39 builds on guidance given in Regulatory Notice 10-06 by providing that firms must be able to retain, retrieve, and supervise business communications regardless of whether they are conducted from a device owned by the firm or an associated person.

Firms or associated persons may not sponsor social media sites or use devices that include technology which automatically erases or deletes content.

[H] Retention

All communications completed by members, brokers, or dealers relating to a firm's business (including originals of all communications received, copies of all communications sent, and approvals granted) must be retained for a period of not less than three years.

[I] Supervision

Firms must supervise interactive electronic communications in a manner reasonably designed to ensure they do not violate the content requirements of FINRA's communications rules as set forth in FINRA Rules 2110 and 2220.

Firms must adopt policies and procedures reasonably designed to ensure that "associated persons who participate in social media sites for business purposes are appropriately supervised, have the necessary training and background to engage in such activities, and do not present undue risks to investors." FINRA Rule 3110 sets forth detailed supervisory parameters. Regulatory Notice 07-59, pertaining to supervision of electronic communications, provides guidance to FINRA Rule 3110.

Firms may use risk-based principles to determine the extent to which proper supervision of their business requires the review of electronic communications.

[I][1] General Elements of Social Media Supervision

- A registered principal must review, prior to use by consumers, any social media site that an associated person intends to employ for business purposes.
- Associated persons should receive appropriate training about such policies and procedures prior to engaging in interactive electronic business communications.
- The firm should monitor compliance of all policies and procedures by associated persons.
- As part of a compliance program, broker-dealers should consider imposing restrictions on social media activity by high-risk associated persons along with corresponding disciplinary action for violations.

§ 49:12 Cybersecurity

Cybersecurity is, at root, the protection of the confidential and business data of an entity from unauthorized access. By virtue of the very nature of investment banking transactions, broker-dealers engaged in investment banking are, at any given time, in possession of valuable and confidential information, making investment banks of all sizes an attractive target for cybersecurity breach.

There are a number of specific federal and state laws relating to either the protection of information that is stored in electronic format. These include federal laws such as the Computer Fraud and Abuse Act (CFAA), which sets criminal and civil penalties for those who illicitly access or modify digitally stored financial records, and important rules promulgated under the Federal Trade Commission Act (FTCA), including the Red Flags Rule, which requires financial institutions and certain creditors to implement procedures protecting consumers against identity theft.[250] Many of the rules that seek to protect the confidential information of individuals are inapplicable to investment banking businesses, inasmuch as those businesses rarely receive personal information.

Similarly, a number of states, including Massachusetts and New York, have also implemented data security rules in recent years. More

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250. SHEARMAN & STERLING CLIENT PUBLICATION, U.S. PRIVACY RULES FOR ASSET MANAGEMENT BUSINESSES: FIVE KEY DEVELOPMENTS FOR 2010 (Feb. 3, 2010), https://www.shearman.com/~/media/files/newsinsights/publications/2010/02/us-privacy-rules-for-asset-management-businesses__/files/view-full-memo-us-privacy-rules-for-asset-manage__/fileattachment/am020310usprivacyrulesforassetmanagementbusinesses.pdf.

important, however, for investment banks, is the guidance and statements of the SEC and FINRA regarding their expectations regarding broker-dealer cybersecurity programs. These documents regard what is at the core of the prudent investment bank's data security program, namely procedures for controlling access to sensitive information and for preventing the loss of that data to accidents and cyber incidents.

§ 49:12.1 SEC and FINRA Cybersecurity Guidance

The SEC and FINRA have provided important guidance regarding broker-dealer cybersecurity obligations under the securities laws and applicable regulations. Not surprisingly, given investment banks' particular data security risks, these guides emphasize the importance of banks implementing, maintaining, and testing procedures for controlling and monitoring access to the firm's sensitive information.

[A] OCIE 2015 Report

In February 2015, the SEC's Office of Compliance Inspection and Examination completed a study of cybersecurity practices in the broker-dealer and investment advisor industries, reporting on the practices of a sample of each type of firm ("OCIE Report").

The OCIE Report found that most such firms had been subject to some form of a cybersecurity breach incident, of varying scale. Most interviewed firms had written information security policies, and the OCIE Report suggests that maintaining policies and procedures that are reasonably designed to enhance cybersecurity is a baseline requirement for broker-dealers.

The OCIE Report also noted that firms' written business continuity plans:

- Often addressed the impact of cyber-attacks on operations.
- Often utilized external best practice standards for cybersecurity management. This was especially true among the broker-dealers surveyed. One of the widely-used standards, NIST, is described below in section 49:12.2.
- Almost all firms used computer encryption to protect at least some sensitive information.
- The vast majority of firms routinely conducted firm-wide cyber risk assessments, identifying threats, vulnerabilities, and potential consequences to cyber intrusion.

- A small majority of broker-dealers and a minority of advisers carried cyber security insurance. Many firms used best practices on sharing of information on cyber-attacks with peers.[251]

[B] FINRA 2015 Report

In February 2015, FINRA issued a report on broker-dealers' cybersecurity practices ("FINRA Report"), aiming to assist firms' efforts to protect client and proprietary information. Among the hallmarks of an effective cybersecurity program, the FINRA Report found foremost to be:

- Sound corporate governance frameworks and strong leadership;
- Routine risk assessments to keep the firm up to date on current threats and vulnerabilities;
- Technical controls (for example, encryption and permission/entitlement) individualized to the firm's needs and business;
- Incident response plans, including containment, mitigation, investigation, and notification procedures that are fully implemented and routinely tested;
- Strong due diligence regarding vendors that handle sensitive data; and
- Cybersecurity intelligence-sharing with other firms and with government.[252]

§ 49:12.2 Frameworks

The National Institute of Standards and Technology (NIST) cybersecurity framework is widely-used and/or used as a reference by investment banks and other financial institutions. The framework "is a set of cybersecurity activities outcomes, and informative references that are common across critical infrastructure sectors, providing the detailed guidance for developing individual organizational Profiles."[253]

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251. SEC OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, CYBERSECURITY EXAMINATION INITIATIVE RISK ALERT 1–2 (Sept. 15, 2015).

252. FINRA, REPORT ON CYBERSECURITY PRACTICES 1–2 (Feb. 2015), https://www.finra.org/sites/default/files/p602363%20Report%20on%20Cybersecurity%20Practices_0.pdf.

253. NATIONAL INSTITUTE OF STANDARDS AND TECHNOLOGY, FRAMEWORK FOR IMPROVING CRITICAL INFRASTRUCTURE CYBERSECURITY 1 (Feb. 12, 2014), https://www.nist.gov/sites/default/files/documents/cyberframework/cybersecurity-framework-021214.pdf.