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## FINRA Releases Concept Proposal on Fixed-Income Research Reports

### Introduction and Overview

Recently, the Financial Industry Regulatory Authority (“FINRA”) issued Regulatory Notice 11-11 requesting comments on a concept proposal to further regulate fixed-income research reports, including through substantive regulation and through additional disclosure requirements.<sup>1</sup> The concept proposal would apply much of the regulation currently in place with respect to equity research to fixed income that is distributed to retail investors, while exempting research provided solely to institutional investors from many of those provisions.

FINRA describes the concept proposal as one that would apply “objective safeguards and disclosure requirements” to fixed-income research with a “tiered” approach that would exempt fixed-income research provided solely to institutional investors from some of the regulation currently required in respect of equity research.

### Background

At present, FINRA’s principal research rules apply only to “equity securities”, and to research analysts that prepare equity securities.<sup>2</sup>

FINRA developed the concept proposal in order to harmonize equity and fixed-income research regulation, and to regulate perceived conflicts of interest in fixed-income research. The proposed rule extends protections similar to equity research to retail investors, while research distributed solely to institutional investors would generally require a more general “health warning,” but would allow such institutional investors to choose to receive the full protections accorded to retail investors, if available.

<sup>1</sup> See FINRA Regulatory Notice 11-11, “FINRA Requests Comment on Concept Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports,” (March 2011). For additional information regarding the regulation of fixed-income research, please see “NASD and NYSE Issue Joint Interpretive Guidance on Fixed Income Research” (August 18, 2006), currently available at [http://www.shearman.com/cm\\_081806/](http://www.shearman.com/cm_081806/).

<sup>2</sup> See NASD Conduct Rules 2711 and 1050.

## Definitions

In the release, FINRA has proposed a definition of “debt research report”, tracking the current definition in NASD Rule 2711 for equity research and subject to the same exceptions in NASD Rule 2711, which in the context of equity research defines a research report as “a communication that includes an analysis of securities and that provides information reasonably sufficient upon which to base an investment decision”.

FINRA proposes to define “debt security” as a “security” other than an “equity security,” a “treasury security” or a “municipal security”.

For purposes of a fixed-income research rule, “institutional investor” would use the definition of “institutional account” as currently appearing in the suitability rule, which would include: (a) a bank, savings and loan association, insurance company or registered investment company; (b) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (c) any other entity (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

As noted above, FINRA contemplates stricter standards for retail fixed-income research than for fixed-income research provided exclusively to institutional investors. This distinction is based on FINRA’s view that there is now “increased retail investment risk in complex fixed-income securities [and]...that the allegations of misconduct in the sale of auction rate securities illuminated this fact and provided a very concrete example that potential conflicts of interest in the publication and distribution of fixed-income research can exist just as they do for equity research.”

## Proposed Standards and Requirements

Most of the provisions of NASD Rule 2711 would be made to apply to fixed-income research. Specifically, the concept proposal would apply the following restrictions and prohibitions on fixed-income research:

DESCRIPTION OF PROVISION	APPLICABLE TO INSTITUTIONAL-ONLY RESEARCH?
Require member firms to establish, maintain and enforce policies and procedures reasonably designed to identify and effectively manage conflicts of interest.	No
Prohibit prepublication review, clearance or approval by investment banking and sales and trading, as well as restrict (or prohibit) such by a subject company (except for fact checking).	No
Prohibit input by investment banking <u>and</u> sales and trading into the determination of the research department budget.	No
Limit the supervision and compensatory evaluation of fixed-income analysts to persons not engaged in investment banking services <u>or</u> sales and trading.	No
Require similar compensation rules and review as equity analysts.	No
Restrict or limit fixed-income analyst account trading in the securities, derivatives and funds related to the securities covered by the fixed-income analyst.	No
Prohibit promises of favorable fixed-income research coverage.	Yes

DESCRIPTION OF PROVISION	APPLICABLE TO INSTITUTIONAL-ONLY RESEARCH?
Prohibit retaliation against fixed-income analysts by investment banking personnel or other employees as the result of an unfavorable research.	Yes
Restrict or limit activities by debt analysts that can reasonably be expected to compromise objectivity, including participation in pitches, road shows and certain three-way meetings involving debt analysts and customers where either investment banking personnel or issuer management are present.	Yes
Prohibit investment banking from directing debt analysts to engage in sales or marketing efforts or any communication with a customer about an investment banking services transaction.	Yes
Review of research by the subject company (beyond fact-checking) or investment banking personnel.	Yes

Further, FINRA envisions disclosures applicable to equity research largely should apply to fixed-income, including:

- personal and firm financial interests;
- receipt of investment banking services compensation from the subject company; and
- the meaning of each rating employed in any rating system used by the member firm in the research report.

### Institutional Investor Exemption

FINRA acknowledges institutional investors trading fixed-income securities regularly do so as counterparties more than as customers of FINRA member broker-dealers. FINRA recognizes that institutional investors value timely flow of analysis and trade ideas related to fixed-income securities, are aware of potential conflicts of interest between a member’s recommendations and trading interests and are capable of exercising independent judgment in evaluating such recommendations and reaching their own pricing decisions. As a result, FINRA suggests that it would be appropriate to exempt fixed-income research disseminated exclusively to institutional investors “from most of the structural safeguards and disclosures described...for retail debt research . . . .”

Provided that the institutional investor does not opt out of the protections being offered by the research, the institution-only exemption would require a “health warning” disclosure on the first page, which would include:

- the research is intended for institutional investors only and is not subject to all of the independence and disclosure standards applicable to research provided to retail investors;
- if applicable, that the firm trades the securities covered in the research for its own account and on behalf of certain clients; such trading interests may be contrary to the recommendations offered in the research and the research may not be independent of the firm’s proprietary interests; and
- if applicable, that the research may be inconsistent with recommendations offered in the firm’s research that is disseminated to retail investors.

FINRA contemplates that institutional investors would be allowed, under a fixed-income research rule, to opt out of the institutional-only exemption, and once opted out, receive only research fully compliant with the requirements for retail investors, if available.

## Communications Firewalls

Communications between fixed-income research analysts and fixed-income sales and trading personnel are critical to the operation of both businesses. Therefore, FINRA suggests permitting certain communications between fixed-income research analysts and sales and trading personnel, while prohibiting others.

The permitted communications would be as follows:

- Provision by fixed-income research analysts to sales and trading personnel of information about the creditworthiness of issuers and other information reasonably related to the price/performance of a fixed-income issuer's fixed-income securities provided that the information is consistent with the analyst's published research. These communications would have to be consistent with similar communications that an analyst might have with the member's customers. They would not be "inconsistent" with published research, however, when discussing investment objectives or time horizons that differ from the analyst's published views.
- Provision by sales and trading personnel to fixed-income research analysts of specific information about a bond instrument, current prices, spreads, liquidity and similar market information relevant to the analyst's valuation of a particular fixed-income security.
- Input from sales and trading personnel to Research Management regarding fixed-income research coverage decisions, provided that final coverage decisions are made by Research Management.

Prohibited communications would expand on current FINRA Rule 5280, which requires information barriers to prevent trading ahead of research reports that would include:

- Attempts by sales and trading personnel to influence a fixed-income analyst's opinion or views to benefit the trading position of the firm, of a customer or of a class of customers;
- Debt research analysts identifying or recommending to sales and trading personnel specific potential trading transactions that are not identified in the analysts' currently published reports;
- Debt research analysts disclosing the timing of, or material investment conclusions in, a pending fixed-income research report; and
- Debt research analysts having any other communication for the purpose of determining the profile of a customer to whom research should be directed.

While certain communications between fixed-income analysts and sales and trading personnel are necessary to allow each to perform their primary functions, the following are expressly prohibited:

- Sales and trading personnel attempting to influence a fixed-income analyst's opinion.
- Debt analysts identifying or recommending specific potential trading transactions to sales and trading personnel not contained in such fixed-income analyst's published reports; disclosing the timing of, or material investment conclusions in, a pending fixed-income research report; or otherwise having any communication for the purpose of determining the profile of a customer.

## Conclusion

FINRA's proposal, once adopted, will add specificity and rigidity to the regulation and management of conflicts of interest in fixed-income research. While a rule embodying this approach cannot become effective for some time (it will, for example,

need to be reduced to a rule proposal submitted to the membership and formally proposed to the SEC for review and approval), it provides insight into FINRA's thinking on the topic and as a reminder that firms should be considering their current policies and procedures for mitigation of conflicts of interest in the preparation and distribution of fixed-income research, and that firms should be considering appropriate changes to policies and procedures in order to meet current requirements and to prepare firm personnel and clients for changes to the business model that are likely to follow regulatory changes.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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