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FINRA Releases Revised Proposal on Fixed-Income Research Reports

Introduction and Overview

The U.S. Financial Industry Regulatory Authority (“FINRA”) recently issued Regulatory Notice 12-09, requesting comments to a revised concept proposal to regulate fixed-income research reports (the “Revised Proposal”). The Revised Proposal follows a concept proposal that was first released in March 2011 (the “Concept Proposal”)¹, which proposed substantive regulation and disclosure requirements for fixed-income research through a “tiered” approach that generally would establish a regulatory regime for fixed-income research that is analogous to that which is in place for equity research. While the Revised Proposal retains this tiered approach, FINRA has incorporated several changes to its original concept based on comments from industry participants. The most important of these changes are:

- The requirement for eligible institutional investors to provide consent before receiving institutional debt research.
- Additional conflicts disclosure requirements pertaining to fixed-income research analysts.
- The elimination of the requirement to disclose the termination of coverage of a debt security.
- The inclusion of requirements regarding the distribution of member and third party research reports.
- An exemption from certain provisions regarding supervision and compensation of fixed-income research analysts for member firms with limited investment banking activity.

FINRA now seeks comments on the Revised Proposal, the comment period for which is set to expire on April 2, 2012.

¹ For additional information about the Concept Proposal, please see “*FINRA Releases Concept Proposal on Fixed-Income Research Reports*”, currently available at <http://www.shearman.com/finra-releases-concept-proposal-on-fixed-income-research-reports-04-27-2011>.

Background

At present, FINRA's principal research rule, NASD Rule 2711, applies only to equity securities and research analysts that prepare research reports relating to equity securities.² 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. Like the Concept Proposal, the Revised Proposal extends regulation similar to that currently in place with respect to equity research to retail investors, while research distributed solely to institutional investors would generally require a more general "health warning," and would allow institutional investors to elect to receive the full panoply of regulation accorded to retail investors, if available.

Definitions

In the Concept Proposal, FINRA defined "debt security" as any "security" other than an "equity security," a "treasury security," or a "municipal security," each as defined in the federal securities laws. The definition of "debt research report" closely followed the definition in NASD Rule 2711 for equity research, which 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.

The Revised Proposal generally maintains these definitions, with one minor change: security-based swaps are excluded from the definition of "debt security." However, FINRA did not rule out including security-based swaps within this definition if such an inclusion is warranted at a later point in time.

In the Concept Proposal, the definition of "institutional account" was the same as "institutional account" as used in FINRA's suitability rule.³ The Revised Proposal maintains this core definition. One notable difference, however, pertains to the election that an institutional investor may make to be treated as a retail investor for the purposes of this rule. Under the Concept Proposal, a person that fell within the definition of institutional investor had the option to elect to be treated as a retail investor and be afforded the protections of the rule. The Revised Proposal now requires eligible institutional investors to provide consent before receiving institutional debt research. Investors who wish to receive only research that is eligible for retail distribution would not be required to take additional steps to receive those protections.⁴

² See NASD Conduct Rules 2711 and 1050.

³ "Institutional Investor" for the purposes of the fixed-income research rule 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.

⁴ This change is not unlike that which was adopted with respect to FINRA's revised suitability regulations, requiring an institutional investor to affirmatively opt out of retail status, rather than permitting FINRA members to rely on objective standards, or to make good faith judgments regarding the sophistication of institutional clients.

Identifying and Managing Conflicts of Interest

Similar to the Concept Proposal, the Revised Proposal requires firms to establish, maintain, and enforce policies and procedures that are reasonably designed to identify and manage conflicts of interest. The Revised Proposal focuses on three aspects of the research business that are perceived to give rise to conflicts of interest:

- The preparation, content and distribution of debt research reports;
- Public appearances by fixed-income analysts; and
- The interaction between fixed-income analysts and those outside the research department.

Within these three areas, the Revised Proposal identifies several sub-categories that firms must consider in developing their policies and procedures aimed at identifying and preventing conflicts of interests regarding fixed-income research reports:

SUB-CATEGORY	POLICY REQUIREMENTS
Prepublication Review	Firms must prohibit prepublication review, clearance or approval of fixed-income research reports by persons involved in investment banking, sales and trading or principal trading and other non-research personnel (other than legal and compliance). Prepublication review of a fixed-income research report by a subject company is also prohibited, other than for verification of facts.
Coverage Decisions	Firms must restrict or limit input by investment banking, sales and trading and principal trading personnel to ensure that final determinations are made independently by research management.
Solicitation and Marketing of Investment Banking Transactions	Firms are required to restrict or limit activities by fixed-income analysts that can reasonably be expected to compromise their objectivity, including prohibiting participation in solicitations of investment banking business and road shows and other marketing on behalf of issuers.
Supervision	Firms must implement policies and procedures to ensure proper supervision of fixed-income analysts that are reasonably designed to promote objective and reliable research.
Budget and Compensation	<p>Budgetary decisions regarding a firm's fixed-income research department must be limited to senior management. However, all persons are permitted to provide input to senior management regarding the demand for and quality of fixed-income research.</p> <p>Firms are prohibited from establishing compensation for fixed-income analysts based on specific investment banking or trading transactions. The Revised Proposal requires an annual review and approval of a fixed-income analyst's compensation, taking into consideration productivity and quality of research and the ratings received from customer and peers independent to the firm's investment banking department.</p>
Personal Trading	Firms must restrict or limit trading by a "debt research analyst account" in securities, derivatives and funds whose performance is materially dependent upon the performance of securities covered by the debt analyst.
Retaliation and Promises of Favorable Research	Firms are required to prevent direct or indirect retaliation or threat of retaliation against fixed-income analysts by any employee of the firm for publishing research or making a public appearance that may negatively impact a current or prospective business interest.

Content and Disclosure of Fixed Income Research Reports

The Revised Proposal imposes most of the same disclosure requirements that apply in the equity research context, with modifications that are intended to reflect differences between the fixed-income and equity markets. These pertain to recommendation and ratings, conflicts disclosure, and termination of coverage disclosures.

Recommendation and Ratings

- Firms must ensure that any purported facts in a fixed-income research report have a reasonable basis. Any recommendation and rating must also be accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede the recommendation or rating.
- While there is no requirement for a firm to adopt a rating system, a firm that chooses to do so must define in each fixed-income research report the meaning of each of its ratings, including the time horizon or any benchmark on which the rating is based.
- Firms must include in each fixed-income research report that includes a rating, the percentage of all securities rated by the firm that the firm would assign a “buy,” “hold,” or “sell” rating. The firm must also indicate the percentage of subject companies in each of those categories for which the firm has provided investment banking services within the previous 12 months.
- Where a firm has rated a debt security for at least one year, the firm must also include in each fixed-income research report all previously assigned ratings to that security and the corresponding dates.

Conflicts Disclosure

The Revised Proposal includes a provision to require firms to disclose all conflicts that reasonably could be expected to influence the objectivity of a fixed-income research report and that are known or should have been known by the firm or fixed-income analyst on the date of publication or distribution. This includes:

- If the fixed-income analyst or a member of his or her household has a financial interest in the securities of the subject company and the nature of such financial interest;
- If the fixed-income analyst has received compensation based upon the firm’s investment banking or sales and trading revenues; and
- If the firm managed or co-managed a public offering of securities for the subject company in the past 12 months, received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months.

The Revised Proposal also provides additional disclosure requirements not originally included in the Concept Proposal. These requirements are provided in the table below:

FIRM CONFLICTS DISCLOSURE	DISCLOSURE REQUIRED?
As of the end of the month immediately preceding publication or distribution of a fixed-income research report, the firm or its affiliates received non-investment banking compensation from the subject company in the previous 12 months.	Yes.
Over the 12-month period preceding publication or distribution of a fixed-income research report, the subject company has been a client of the firm.	Yes. Arrangement and types of services provided to the subject company must be disclosed.
The firm trades or may trade as principal in the debt securities (or in related derivatives) that are subject of the fixed-income research report.	Yes.

FIRM CONFLICTS DISCLOSURE

The firm or its affiliates maintain a significant financial interest in the debt or equity of the subject company, including, at a minimum, if the firm or its affiliates beneficially own 1 percent or more of the subject company.

DISCLOSURE REQUIRED?

No. FINRA has eliminated this specific disclosure provision in the Revised Proposal. Disclosure is only required where the firm (or its affiliate) has a debt or equity position in the subject company where the position amounts to a material conflict of interest that the fixed-income analyst knows or has reason to know at the time of publication or distribution of the fixed-income research report.

The Revised Proposal provides that disclosures need not be made if they would reveal material non-public information regarding specific potential investment banking transactions relating to the subject company.

Termination of Coverage

The Concept Proposal included a provision parallel to the equity rules that would have required a firm to promptly notify its customer if it intends to terminate coverage in a debt security and include with the notice a final research report. FINRA recognized that firms may have an extensive coverage universe of debt securities that may only be the subject of episodic research coverage. As a result, FINRA has eliminated the requirement to disclose the termination of coverage from the Revised Proposal.

Public Appearances

The Revised Proposal closely parallels the equity research rules with respect to disclosures during public appearances. Thus, fixed-income analysts in public appearances must make disclosures where:

- The analyst and his or her household member's financial interest in the subject company;
- If the analyst knows or has reason to know that the firm or any affiliate received compensation from the subject company in the previous 12 months;
- If the analyst knows or has reason to know that the subject company has been a client in the previous 12 months and the nature of services provided; and
- The analyst knows or has reason to know at the time of the public appearance of any other material conflict interest of the fixed-income analyst or firm.

The Revised Proposal does not require disclosure where doing so would reveal material non-public information regarding specific potential future investment banking transactions. Firms are required to maintain records of public appearances sufficient to demonstrate compliance with the disclosure requirements.

Standards Applicable to Research Distributed to Institutional Investors

The Revised Proposal exempts research distributed solely to eligible institutional investors ("institutional debt research") from most of the provisions relating to supervision, coverage determination, budget, and compensation determination and all of the disclosure requirements applicable to fixed-income research reports distributed to retail investors ("retail debt research"). However, the prohibitions of prepublication review, solicitation and marketing of investment banking

transactions, and the retaliation and promises of favorable research still apply (subject to the information in the chart below).

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 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
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

The Revised Proposal requires institutional debt research to carry general disclosures prominently on the first page of the report that: (i) the report is intended only for institutional investors and is not subject to all of the independent and disclosure standards of retail debt research reports; (ii) if applicable, that the views in the report may differ from the views offered in retail debt research reports; and (iii) if applicable, that the report may not be independent of the firm’s proprietary interests, and that the firm trades for its own account and for customers, and such trading interests may be contrary to any recommendation in the report.

Finally, the Revised Proposal requires firms to implement policies and procedures reasonably designed to ensure that institutional debt research is made available only to eligible institutional investors. A firm may not rely on the exemptions for institutional debt research if it has reason to believe that the research will be redistributed to a retail investor.

Communications Firewalls

The Concept Proposal outlined certain permissible and prohibited communications between fixed-income analysts and sales and trading personnel. In doing so, FINRA states that it intended to allow communications essential to the discharge of the primary functions of debt analysts and sales and trading personnel while at the same time preventing undue influence on

fixed-income analysts to generate or conform research to a firm's proprietary trading interests or those of particular customers. FINRA received several comments suggesting that the prohibitions were too restrictive. In response, the Revised Proposal clarifies that (1) sales and trading and principal personnel may communicate customers' interests to research personnel, so long as fixed-income analysts do not respond by publishing research that is intended to benefit any trading position of the firm or its customers;⁵ and (2) fixed-income analysts may provide customized analysts and recommendations to sales and trading personnel and customers, provided that such communications are not inconsistent with the analyst's currently published or pending research report.

Distribution of Member and Third-Party Research Reports

The Revised Proposal requires firms to establish policies and procedures that are designed to ensure that the firm does not selectively distribute a fixed-income research report to trading personnel or a particular customer. The supplementary material included in the Revised Proposal explains that this provision does not preclude offering different research products to different customers, so long as the product is not differentiated only by the timing of receipt of recommendations, ratings or other potential market-moving information.

The Revised Proposal also incorporates the current standards for third-party equity research paralleling the language used in NASD Rule 2711(h)(13). Thus, a firm need not review independent third-party debt research prior to distribution and may not have to include certain otherwise applicable disclosures depending on whether the research is "distributed" or "made available."

If independent third-party research is distributed, a member firm would be required to accompany or provide with the research report a web address directing recipients to disclosure of any material conflicts of interest that can reasonably be expected to have influenced the choice of the research report provider or the subject company of the report.⁶

Firms must have procedures to ensure that non-independent third-party debt research, including affiliate research, contains no untrue statement of material fact and is not otherwise false or misleading. Such review extends to false or misleading information that should be known from a reading of the report or is actually known based on other information firms possess. Prior approval is not required and the review procedures that a firm adopts can be risked-based.

Finally, the Revised Proposal requires third-party research to be labeled as such. It must be reliable and objective and discloses any material conflict of interest that can reasonably be expected to have influenced the choice of third-party research provider or the subject company of a third-party debt research report.

⁵ The Revised Proposal's focus on proprietary trading of fixed-income as a source of conflicts raises many questions relating to the application of customer-driven, proprietary activities such as market-making and customer facilitation.

⁶ For the purposes of this rule, a member firm shall not be considered to have distributed an independent third-party debt research report where such research is made available by a member firm (a) upon request; (b) through a member-maintained website; or (c) to a customer in connection with a solicited order in which the registered representative has informed the customer, during the solicitation, of the availability of independent debt research on the solicited debt security and the customer requests such independent debt research.

Exemption for Members with Limited Investment Banking Activity

The Revised Proposal exempts from certain provisions regarding supervision and compensation of fixed-income analysts those firms that over the previous three years, on average per year, have participated in 10 or fewer investment banking services transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions. This is the same metric used for an exemption from certain provisions of the equity research rules.

Conclusion

FINRA's Revised 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 and direction. Perhaps of greatest concern, the Revised Proposal includes even greater rigidity and specificity in its proposal to regulate perceived conflicts of interest between research and sales and trading, which business research exists to support. While FINRA's focus in this regard is proprietary trading of fixed-income, difficult interpretive questions arise, given that the vast majority of trading in fixed-income instruments is principal trading. The establishment of barriers between research analysts and sales and trading personnel is a major change to the sales and trading businesses, the consequences of which are at this point largely unknown.

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.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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