



FINRA Proposes Revised Rule Involving the Preparation and Distribution of Debt Research Reports

On October 11, 2012, the Financial Industry Regulatory Authority (“FINRA”) issued a revised proposal to address debt research conflicts of interest that includes amending proposed exemptions for research distributed to certain institutional investors and for firms with limited principal debt trading activity. The revised proposal also includes other changes in response to comments on a prior proposal set forth in Regulatory Notice 12-09.

This alert summarizes the proposed exemptions and rule changes found in FINRA’s Regulatory Notice 12-42.

Background

In February 2012, FINRA requested comment on a proposal to address debt research conflicts of interest. That proposal, set out in Regulatory Notice 12-09, generally provided retail customers with the same extensive protections provided to recipients of equity research, while exempting debt research distributed solely to eligible institutional investors (institutional debt research) from many of those structural protections, as well as prescriptive disclosure requirements.

The February 2012 proposal defined “institutional investor” as an “institutional account” in FINRA Rule 4512(c). Thus, the proposed definition would cover: (a) a bank, savings and loan association, insurance company or registered investment company; (b) an investment adviser registered either with the Securities and Exchange Commission (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. Eligible institutional investors were required to affirmatively notify a member firm in writing if they wished to receive institutional debt research and forego the “retail” protections of the rule. The proposal also included an exemption from the review, supervision, budget and compensation provisions for broker-dealers that engage in limited investment banking activity. Regulatory Notice 12-09 also asked for input on a potential exemption for firms with limited principal trading activity or revenues generated from debt trading.

In response to comments and other industry feedback, FINRA has revised the proposed exemptions as detailed below. FINRA has requested comments on the scope and content of each of the proposed exemptions; the comment period expires on December 10, 2012.

Exemption for Institutional Debt Research

Several commenters raised issues regarding the provision that requires otherwise eligible institutional investors to affirmatively elect to receive institutional debt research. These commenters asserted that the provision is

unnecessarily burdensome and may result in excluding a significant number of institutional investors from receiving the debt research that they receive today.

FINRA now proposes to establish a higher tier of institutional investors that could receive institutional debt research without their written agreement. Instead, the broker-dealer could obtain agreement by way of negative consent, if the institutional investor chose not to notify the firm that it wishes to be treated as a retail investor. The higher tier exemption would be available to an institutional investor that:

1. meets the definition of Qualified Institutional Buyer (“QIB”); and
2. satisfies the new FINRA Rule 2111 institutional suitability standards, which require that:
 - i. the member firm has a reasonable basis to believe that the institutional investor is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a “debt security” or “debt securities,” as defined in the proposed debt research rules; and
 - ii. the QIB has affirmatively indicated that it is exercising independent judgment in evaluating the firm’s recommendations pursuant to the suitability rule, provided such affirmation covers transactions in debt securities.

The affirmation need not specify transactions in debt securities but must be broad enough to fairly encompass such transactions. Other institutional investors that meet the definition of FINRA Rule 4512(c), but do not satisfy the higher tier requirements, could still affirmatively elect in writing to receive institutional debt research. Retail investors could not choose to receive institutional debt research.

Exemption for Firms with Limited Principal Debt Trading Activity

The revised proposal includes for the first time an exemption for firms with limited principal debt trading activity. The exemption extends to firms that have (1) gains or losses (in absolute value) of less than \$15 million from principal debt trading activity on average over the previous three years and (2) fewer than 10 debt traders. Firms that satisfy these criteria would be exempt from provisions that require separation between debt research analysts and those engaged in sales and trading and principal trading activities with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination.

For the purposes of the exemption, a debt trader is defined as “a person, with respect to transactions in debt securities, who is engaged in proprietary trading or the execution of transactions on an agency basis.” Firms that rely on the exemption must document the basis for their eligibility and maintain for a period of not less than three years records of any communication that, but for this exemption, would be subject to the prohibitions regarding pre-publication review by sales and trading and principal trading personnel.

Exemption for Firms with Limited Investment Banking Activity

The revised proposal maintains an exemption imported from the equity research rules for firms that engage in limited investment banking activity. Specifically, it excludes those firms that during 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. The proposal exempts eligible firms from provisions that require separation between debt research analysts and investment banking personnel with respect to pre-publication review of debt research, supervision and compensation of debt research analysts and debt research budget determination.

Other Changes

The revised proposal also makes clarifying and conforming changes in response to comments received on the proposal in Regulatory Notice 12-09. These include:

- Definition of “debt research report”—conforms the definition of “debt research report” to the SEC’s Regulation Analyst Certification definition and clarifies that the definition covers an analysis of either a debt security or an issuer and excludes reports on types or characteristics of debt securities. The proposal also includes all of the exceptions to the definition in the rule text.
- Disclosure of Conflicts—requires disclosure of material conflicts that are known or should have been known by the member firm or debt analyst at the time of publication or distribution of the report. This standard replaces the requirement in the previous proposal to disclose “all conflicts that reasonably could be expected to influence the objectivity of the debt research report.”
- Compensation Disclosure for Foreign Sovereign Debt—provides that, in lieu of disclosing investment banking compensation received by a non-U.S. affiliate from foreign sovereigns, firms may instead implement information barriers between that affiliate and the debt research department to prevent direct or indirect receipt of such information. However, disclosure still is required if the debt analyst has actual knowledge of receipt of investment banking compensation by the non-U.S. affiliate.
- Road Show Prohibition—clarifies that the prohibition applies only with respect to road shows and other marketing activities on behalf of an issuer “related to an investment banking services transaction.”
- Prohibition on Joint Due Diligence—deletes the provision that prohibited joint due diligence by debt research analysts and investment banking personnel, conforming to the equity research rules and a change to the Global Settlement.
- Valuation Method Disclosure—requires explanation of a “valuation method used” only where a specific valuation method has been employed.
- Research Analyst Interactions with Sales and Trading—adds clarifying language to the rule text that, in determining what is inconsistent with an analyst’s published research, firms may consider the context, including that the investment objectives or time horizons being discussed differ from those underlying the analyst’s published views.

For additional information, please see FINRA’s recently released Regulatory Notice 12-42, which can be found at the following link: <http://www.finra.org/Industry/Regulation/Notices/2012/P187304>.

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